THE FREEMAN
IDEAS ON LIBERTY
VOLUME 57, NO 3 APRIL 2007

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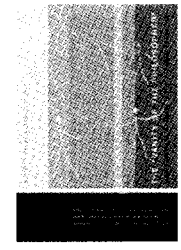

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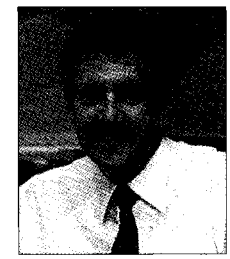
Ending the Welfare State Through the Power of Private Action



BY RICHARD M. EBELING

Despair about the current direction of American public policy is easily understood. In whichever direction we look, government seems to be growing larger and more intrusive. For example, in February the Associated Press (AP) reported that in spite of the 1996 welfare reform, which has reduced the number of people on the welfare rolls, "Nearly one in six people rely on some form of public assistance, a larger share [of the population] than at any time since the government started measuring two decades ago."

Those receiving welfare payments from the federal or state governments may have decreased from 14.2 million people in 1994 to 5.1 million in 2005. But 45 million people are on Medicaid, the AP said, and almost 26 million people receive food stamps every month.

Government continues to be out of control, and too many of our fellow Americans appear not to care enough to do anything about it, especially when so many of them are beneficiaries of government largess in one form or another. A disregard of the harmful effects from any and all forms of dependency on the welfare state is reinforced by the media, which almost always implies there "ought to be a law" to solve every supposed social problem, and a public-education establishment that indoctrinates young people in our schools and colleges with "politically correct" propaganda for political paternalism.

But appearances do not always tell the real story of everything that is going on. People often act more wisely in taking personal initiative and reclaiming self-responsibility than their stated or unstated political views would suggest. I believe that while many Americans find it difficult to think politically "outside the box" of Big Government, they have in fact lost confidence in much of what government has promised or tried to deliver. As this confidence has been eroded, people have begun once more to take care of themselves and their families.

Social Security is one area where this is happening. While most Americans cannot imagine a world without a government-guaranteed pension, a growing number of Americans have been turning their backs on this government promise of a secure and comfortable retirement. Over the last 20 years private retirement planning has exploded. In 1985 there were 1,528 mutual funds offering investment opportunities to private investors. By 2004, however, 8,044 mutual funds existed. Total mutual-fund assets increased from $495 billion to 8.1 trillion. The number of shareholder accounts went from 296,000 to over 267.4 million.

This tells us the extent to which the American people have implicitly declared that they have no confidence in Social Security. Whether they are setting aside before- or after-tax income, tens of millions of Americans have decided that they cannot and will not depend on Washington when they retire and are planning for their own future.

Another example is education. For well over a century compulsory public education has been one of the most sacred cows of public policy. The few private schools have often been viewed as only for the children of the elite. And 20 years ago, homeschooling was considered eccentric or for the shut-in child.

Yet between 1990 and 2004 attendance at private schools (K–12) increased from 4.8 million to over 6.2 million, a 29 percent increase. About 11.5 percent of all students in the United States are now enrolled in more than 29,000 private schools; these schools represent around 23 percent of all schools in the country. A national survey in 2000 found that 48.6 percent of the schools were Catholic, 15.7 percent nonsectarian, 15 percent conservative Christian, 6.1 percent Baptist, 4.3 percent Lutheran, and 3.3 percent Jewish. Many of the remaining private schools also were affiliated with religious denominations.

The parents of these privately schooled children

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choose to pay tuition on top of their school taxes. According to many studies, the growth in private schooling would be greater if not for the tax burden on the average family, including those taxes for the government schools many parents wish to shun.

In a 1985 public-opinion poll, only 16 percent of respondents thought homeschooling was a good thing; but by 2001 41 percent gave that response. In the early 1990s an estimated 400,000–600,000 children were being homeschooled. Today, well over one million children may be homeschooled.

Homeschooling parents are willing to bear another heavy burden to assure their children's education. They not only pay taxes for a government school their children do not attend, but one parent gives up the opportunity to earn income in the workplace by staying home, mastering many academic subjects, and teaching.

As a percentage of all students enrolled throughout the United States, the numbers for both private- and homeschooled children are still relatively low, totaling no more than around 12 percent of the student population.

But the parents of these young people no longer trust government education. Some parents oppose what is taught in government schools, believing that wrong values and beliefs are fostered there. Others are angered and frustrated that their children do not learn to read. They understand that their children only get one chance to be educated while they are young and will not leave that one chance to the government—regardless of the cost to the family.

The enthusiasm of many parents for the voucher system is also a strong indication of how much they want to reduce government control over their children's education. Even if the friend of freedom has doubts about the workability of the voucher system, and whether it would really free education from the state monopoly, its growing popularity demonstrates that many parents want to take greater responsibility for their children's schooling.

Health-Care Revolt

Even while the Medicare and Medicaid rolls are growing, a "counterrevolution" against government-provided health care is starting. A handful of physicians have begun to opt out of the system and all the paperwork and regulations socialized medicine entails. They only accept patients who are willing to pay out of their own pockets, rather than with government dollars taken from the taxpayers. Some of their patients gladly follow their doctors out of the labyrinth of government medical care as they learn that by doing so the long-run cost of their medical services could fall. In addition, these patients rediscover the benefits of more directly choosing the type and quality of care they desire. And it helps restore the personal relationship between doctor and patient that government health care has severely undermined.

In these three areas individuals are taking back personal responsibility from the government. They are not waiting for a political movement to "free" them. Instead, their actions preceded and sparked the political debate over whether government should monopolize these services.

These individual private choices rarely capture the headlines. But like many real social shifts they are occurring all around us, slowly and incrementally through the separate actions of millions of people. Their cumulative effect has the potential to transform society.

This is also the reason for long-run optimism about the prospects for liberty. The American heritage of freedom still is the fertile soil in which individuals can challenge the idea of political paternalism. By taking care of their own affairs, they are delegitimizing the welfare state. Their actions then influence the arena of ideas.

The paternalistic state was not created in a day. It has grown in size and legitimacy over a century, and it will not be gone in the blink of an eye. But it is being undermined by a real "people's" movement, the spontaneous choices and actions of millions of Americans wanting greater self-responsibility and less dependency on the powers that be. They are moving the world away from the welfare state one person at a time. That is the strength and the power of liberty.

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THE FREEMAN
IDEAS ON LIBERTY

Published by
The Foundation for Economic Education
Irvington-on-Hudson, NY 10533
Phone: (914) 591-7230; E-mail: freeman@fee.org
www.fee.org

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The Foundation for Economic Education (FEE) is a non-political, non-profit educational champion of individual liberty, private property, the free market, and constitutionally limited government.

The Freeman is published monthly, except for combined January-February and July-August issues. To receive a sample copy, or to have *The Freeman* come regularly to your door, call 800-960-4333, or e-mail bhoffman@fee.org.

The Freeman is available on microfilm from University Microfilm International, 300 North Zeeb Road, Ann Arbor, MI 48106.

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Cover cartoon: Tim Kelly

Perspective

Fiscal Force

"I know ev'rybody's income and what ev'rybody earns;
And I carefully compare it with the income-tax returns."

—W.S. Gilbert, *Princess Ida*

April is the cruelest month, for reasons other than what T.S. Eliot had in mind. This is the month in which you must account for yourself to Caesar. The authorities, having relieved you of a goodly portion of your earnings before you even caressed the bank-notes between your fingers, now demand you show cause why you should not remit still more.

And in further demonstration of the principle that the citizen in this beloved democracy is the master and the government the mere servant, you are requested to affix your signature beneath these calming words: "Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete."

Those who deem such threats—I mean words—harsh have clearly not visited the friendly IRS website. There you will find much useful information, including the "truth about frivolous tax arguments." These are the sundry—and *legally* baseless—claims that no American citizen is obliged to pay income tax.

The first "frivolous argument" is that the income tax is voluntary: "Proponents point to the fact that the IRS itself tells taxpayers in the Form 1040 instruction book that the tax system is voluntary." Considering the source of the argument, it might seem something more than frivolous. But, alas, the government subscribes to the Humpty-Dumptian philosophy of language found in Lewis Carroll's *Through the Looking Glass*: "'When *I* use a word,' Humpty Dumpty said, in rather a scornful tone, 'it means just what I choose it to mean—neither more nor less.'"

As the IRS explains, "The word 'voluntary,' as used in *Flora* [*v. United States*] and in IRS publications, refers to our system of allowing taxpayers to determine the correct amount of tax and complete the appropriate returns,

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rather than have the government determine tax for them. . . . |T|he court clearly states, 'although Treasury regulations establish voluntary compliance as the general method of income tax collection, Congress gave the Secretary of the Treasury the power to enforce the income tax laws through involuntary collection.' "

The IRS is right. The law spells out the penalties for not filing and not paying. So in other words, if one should choose *not* to volunteer to determine the correct amount of tax and complete the appropriate returns, one will be visited by an armed taxman.

As one observer has noted, the income tax is voluntary in the same way stopping at stop signs is voluntary. A voluntary tax is a contradiction in terms.

P.S.: We taxpayers don't have to file until April 17 this year. Here's the IRS's explanation: "Taxpayers will have extra time to file and pay because April 15 falls on a Sunday in 2007, and the following day, Monday, April 16, is Emancipation Day, a legal holiday in the District of Columbia."

This actually makes sense. It would be ridiculous to have Re-enslavement Day fall *before* Emancipation Day, wouldn't it?

★ ★ ★

This tax season there is good news and bad news. The good news is that people are discontent with the income tax. But the bad news, D. W. MacKenzie points out, is that most people want someone other than themselves to bear the brunt of it.

April 22 is Earth Day, but if life on earth is the standard, perhaps the wrong thing is celebrated that day. John Semmens explains.

The welfare state comes in for lots of criticism by defenders of freedom. However, Robert Murphy thinks one type of welfare gets too little attention: corporate welfare.

When government ventures down the road to "social justice," it does so on the premise that people do not deserve their good fortune. That's a big mistake, writes Anthony de Jasay.

It's widely believed that government must precede the institution of private property and social cooperation. Yet in many ways America belies that notion, as Andrew Morriss documents in the last of his series on property in America.

Many states are moving to centralize the regulation of cable-television franchising. It looks like a promising reform, but be careful what you ask for, says Adam Summers.

If the market order emerges spontaneously through built-in incentives to act for mutual interest, where does ethics enter the picture? Does ethics enter at all? Douglas Den Uyl and Douglas Rasmussen resolve the paradox.

Here's what our columnists have cooked up: Richard Ebeling finds hope in people deserting the welfare state. Donald Boudreaux says if we ignore the life-saving nature of the market economy, fixes for possible global warming will be lethal. Robert Higgs traces the causes of the Great Contraction that began in 1929. Charles Baird looks at F. A. Hayek's views on unions. And Jude Blanchette, reading Michael Kinsley's claim that the price of stocks is irrational, protests, "It Just Ain't So!"

Books on big-government conservatism, diversity, classical economics, and lawyers come under review.

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The Stock Market Is a Swindle? It Just Ain't So!

BY JUDE BLANCHETTE

Michael Kinsley, founding editor of the online magazine *Slate*, columnist for the *Washington Post*, and American editor of the *Guardian* (UK), is a smart guy. His columns are often witty and incisive. Even where Kinsley is wrong (and he often is) he provides the reader a valuable lesson in critical thinking.

So perhaps we can forgive him for his November 26, 2006, *Post* column, "A Capitalist Swindle." Virtually every sentence contains a factual, analytical, or theoretical error. It starts with small tips of the hat to the then-recently deceased Milton Friedman, the ability of capitalism to set the price of potatoes, and the fact that some things that wear the mantle of capitalism are not in fact capitalism. So far so good, but after reading the entire piece, one wishes that Kinsley had dropped his pen there.

But he didn't. The gist of Kinsley's article is that the folks of Middle America are being swindled out of their money via financial trickery.

> Private investors buy a company from its public stockholders. They have a letter from an investment bank saying the price is a fair one. They usually have the support of management, or they actually are the management. The public stockholders have little choice. [!] But time and again—surprise, surprise—the investment bank turns out to be wrong. The company is actually far more valuable!

These Wall Street mavens swoop down on unsuspecting shareholders, rip the company from their grip, swipe a hefty dose of profits, and then turn around and sell the company for a nifty return.

"The free market cannot be setting the right price for financial assets such as shares of stock because often there are different prices with equal claims to be the product of free-market capitalism. They can't all be right," Kinsley says.

> Someone with a keener imagination about a company's potential is often able to buy the company at what later looks like a bargain price from someone with a less-keen imagination.

Sigh. To begin, no one rips stock from the hands of shareholders. If the offer isn't attractive, the shareholder doesn't have to sell. Next, contrary to Kinsley's assertion, there can be many different prices for a given good. Take a simple example. Not far from my apartment in Shanghai there is a clothing market frequented by locals and tourists. If you were to plant yourself outside a particular shop you would hear umpteen different prices quoted for the same shirt, depending on the time of day, the amount of traffic in the shop, the supply of shirts in the back storage room, and the purposes, gullibility, or ignorance of the customer. Different buyers and sellers are willing to accept different prices for the same thing. All the more for something as complex as a company or shares in a corporation.

But I gather Kinsley has a different point in mind, namely that private-equity firms game the system and

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extract profits that would otherwise go to shareholders. Typically, a private-equity firm acquires majority ownership of a company, or a company's managers purchase it and take it private. When the company's value is used to borrow the money that makes the purchase possible, it's called a leveraged buyout. If successful, the new owners later sell the shares for a nice profit. Kinsley's suspicion and criticism are only the latest from government regulators, investors like Warren Buffett, and pundits who presumably want more government regulation.

Kinsley continues, "The stock market leaves money on the table waiting for 'private equity' to swoop down and pick it up." Depending on how literally one wants to read Kinsley, this could be considered a true statement. But the act of spotting and then "picking up" this (potential) value is, in fact, the process by which that market moves toward greater efficiency. What Kinsley misses in private equity's swoop is the value added after the purchase. Once in the buyers' control the vast majority of companies go through restructuring—a process that often is slow and laborious when the company is publicly held. Restructuring is based on a plan devised by those who acquire the stock. That accounts for the different prices: the value of assets does not flow from their mere physical nature but from ideas about how they might be used. Assets held under one set of ideas are not equal in value to the same assets held under another set. Someone with a keener imagination about a company's potential is often able to buy the company at what later looks like a bargain price from someone with a less-keen imagination. There's nothing suspect about that.

Is there value added in leveraged buyouts? One way to assess this is to look at the companies when they are reintroduced as IPOs (initial public offerings), a process known as a reversed leveraged buyout (RLBO). According to research by Josh Lerner of Harvard and Jerry Cao of Boston College, "Reverse LBOs appear to consistently outperform other IPOs and the stock market as a whole. The positive returns appear to be economically and statistically meaningful. Moreover, there is no evidence of a deterioration of returns over time, despite the growth of the buyout market: RLBOs performed strongly in the late 1980s, the mid-1990s, and the 2000s." To reach these findings, Lerner and Cao analyzed 496 RLBOs between 1980 and 2002. Lerner says that his and Cao's findings are "inconsistent with many of the claims in the press." Perhaps they had a certain *Post* columnist in mind.

So once the fruit of the private-equity–led restructuring is allowed to ripen, we more often than not see that the process has yielded value for the company, for investors, and for the economy as a whole, which now has a more efficiently run company in its midst. Some in the press are quick (and right) to point out many of the unseemly practices of some private-equity groups, but it appears that these cases are isolated.

Moving beyond the evidence, let us suppose for a moment that Kinsley is correct, that markets can't accurately price company shares and that private equity yields no benefits. What mechanism does Kinsley propose for getting prices "right"? On this point he is silent. It's hard to imagine government regulators with better knowledge than market traders. No, it's impossible. For all the faults of private equity, indeed, for all the faults of any human endeavor, it's hard to see how handing power over to the corporatist state would help.

I'd like to return to two earlier statements Kinsley made in the piece. The first, as previously mentioned, is that some things "masquerade as capitalism at work and claim its virtues, but aren't. . . ." Astoundingly, two sentences later, Kinsley remarks, "To all appearances, the stock market is capitalism operating under near-laboratory conditions." Can he really mean the American stock market? The financial sector in the United States, despite what the media report, is so highly regulated that it's hard to term it private. This is not a tale of America's most persecuted minority, but rather a more twisted saga of big business and big government in collusion. North Korea the American economy is not, but let's not delude ourselves into thinking any aspect of our markets is laboratory-like.

Kinsley studied economics at Harvard, which perhaps explains his willingness to wade into economic and financial matters. But he obviously didn't learn much about the economics of the stock market there, which indeed explains why this column was so dreadfully bad.

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Tolls on the Road to Serfdom

BY D.W. MACKENZIE

Many people think their taxes are too high and that the tax system is unfair. While those who favor individual liberty might find this encouraging, the specific reasons for discontent are not entirely positive. Many Americans think the current system is unfair because of *how* it affects income distribution and intervenes in markets. That is, most Americans think that the tax system should redistribute and intervene—just in a different way.

There are many arguments against using taxes to redistribute income and reallocate resources. Economists like Gordon Tullock and Mancur Olson have explained why we should expect much special-interest bias and waste (rent-seeking) in large activist government. Public-opinion polls indicate that people oppose special-interest bias and waste in the tax system. However, lots of Americans see the system as a means of partial economic planning for the achievement of "social goals" like poverty reduction or pollution abatement. In his classic book *The Road to Serfdom* F.A. Hayek explained why comprehensive economic planning would ultimately destroy individual liberty. Tax policy in the United States does not aim at comprehensive planning, but it does serve as a vehicle of partial planning. A close examination of public discontent over taxes and the tax system itself reveals that the use of income taxes as a means of partial economic planning has already resulted in a loss of individual liberty.

An Ipsos poll last year noted that 58 percent of Americans believe the middle class pays too much in taxes. Fifty-four percent believe the poor pay too much. Sixty percent believe the rich do not pay enough. Others complain that the top 5 percent of income earners pay too much. Still others say the top 5 percent get too many tax breaks. Small businesses and the self-employed pay too much, while large businesses pay too little, according to this poll.

Complaints also target the tax code's complexity and lobbyist influence. These are valid complaints. The Standard Federal Tax Reporter has 66,498 pages of federal tax rules. These rules are incomprehensible. A slight majority of Americans hired a professional to work on their tax returns this year. This work was done by 1.2 million professionals and generated revenue of $2.4 billion for H&R Block alone. Some people think that a flat tax rate of 17 percent would solve this problem. Other people favor consumption taxes or value-added taxes. Still others favor heavy tariffs to protect American industries.

Thus most of the discontent with federal taxes and spending is with the current form of fiscal redistribution and fiscal activism, not with redistribution and fiscal activism itself. Most Americans disapprove of the current fiscal structure of government, but not because they oppose any form of high and complex taxes, which large activist governments require. To put it simply, most Americans want a tax system tailored to their own political or ideological beliefs, one that would tax different people according to what they each see as fair.

One might say that this is simply democracy in action. In a democratic society different people assert different points of view and enlightened public debate resolves these differences. There are sound reasons to doubt this is the case. In *The Road to Serfdom* Hayek argued that democracy functions best when it is limited

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to enforcing a few general rules of conduct that do not favor any particular group or individual. Rules concerning which side of the street we should drive on are uncontroversial. Rules against violent crimes are essential to the functioning of any society. Constitutional rules guaranteeing free speech and free association are necessary for promoting freedom. A democracy that enforces a few simple and common-sense rules can function without threatening individual liberty.

Problems arise when we attempt to use democracy toward specific ends. The difference here is between enforcing general rules of conduct without aiming at any particular outcomes and activist government that tries to bring about particular outcomes. A limited government would need to raise revenue for only its limited purposes. An activist government uses taxes to achieve broader purposes: to redistribute income from less to more "deserving" people, to protect the environment, to protect American jobs, or to achieve some notion of "social justice." We do not, and can never, agree on which of these priorities is the most important. As Hayek wrote, any attempt at such social planning will derive from an incomplete set of values. Different people will have different views on such matters. The attempt to form a single plan necessarily favors some views at the expense of others. Only a few can see their views put into action through tax policy.

Consequently, the attempt to plan even part of society through tax incentives or redistribution will be based on a "partial scale of values" that will leave most people discontent. People who think that the tax system would be fair if *their* views were adopted should realize that each of their views is only one among many and that most differences over policy can *never* be resolved in a society of independent thinkers. The form of discontent revealed in recent polls is simply a product of the forces Hayek described.

Worse still, activist government is vastly complex. In a complicated and changing world elected officials must delegate substantial powers to bureaucrats. As Hayek noted, parliaments that assume an activist role in planning society will become "ineffective talking shops." So elected officials must delegate discretionary powers to bureaucrats who can judge particular cases on their individual merits. This is in fact what has happened with the IRS. The tax code is not only complex but vague. Ambiguity allows IRS auditors discretion in how they enforce the code. In the 1990s congressional hearings on the IRS revealed many instances of officials' abusing their authority.

"The Worst Get on Top"

Of course, one could dismiss these cases as anecdotal evidence from one particular period. However, Hayek demonstrated that "the worst get on top" of any government that seeks to plan economic activity, and this rule doesn't apply only to heads of state. He noted that "To be a useful assistant in a totalitarian state, it is not enough that a man should be prepared to accept specious justification of vile deeds; he must be prepared to break every moral rule he has ever known if this seems necessary to achieve the ends set for him." When it comes to competing over governmental power, those with good intentions and high ideals are always at a disadvantage with those who will stop at nothing to acquire more power. Of course, the IRS is not a part of a totalitarian government. Yet it is a part of an activist government that attempts to do far more than enforce a few simple rules.

We have not traveled the full length of Hayek's road to serfdom, but we have gone far enough to see where it leads. The IRS hearings revealed more than the abuse of taxpayers. Whistleblowers at the agency had their careers ruined. Thus fair-minded persons there could not advance to positions of authority. Only those willing to stop at nothing to achieve IRS goals could reach such positions. This strongly supports Hayek's contention that those who acquire discretionary powers in government are not trustworthy.

Many of the more common concerns with the tax code are legitimate. Tax compliance is costly, and the laws favor special interests. Yet the discontent that most Americans have with the tax code is no cause for optimism. Since most of them want to change the tax system to reflect their conception of social justice, we must conclude that they are intent on taking at least a few more steps toward serfdom. This is cause for concern but not for hopelessness. Our primary task is to convince the public that they have come to expect too much of democracy.

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Freedom Is the Environment's Best Friend

BY JOHN SEMMENS

Every April 22 celebrations of Earth Day take place around the world. This can serve as a reminder to reflect on the status of our planet. Some believe the earth is in great peril and that stringent measures to restrain economic development and technology are necessary to avoid a horrible fate. These measures are guided by three key concepts.

One concept is "sustainable development." The idea here is to minimize the use of nonrenewable natural resources so there will be more left for future generations. While the idea sounds good, there are some problems with trying to enforce it through government restrictions.

There is no such thing as a "natural resource." Nature doesn't determine what is a resource. Human wants and ingenuity determine this. In this sense, all resources are manmade. Nonsense, you say. Man didn't make the petroleum in the ground. Nature did.

It isn't the substance of petroleum that makes it a resource. It is the use to which it can be put that makes it so. Time was when finding oil on your property was a bad thing. It could poison livestock and ruin prime cropland. Between then and now, human brainpower has figured out how to put this substance to good use as a fuel for motor vehicles and an ingredient in plastics, among other things. So today petroleum is a resource.

Whether petroleum will be as crucial in the future as it is now is unknown. It is likely that it will not be. The history of technology indicates that new methods continually replace old methods. For tens of thousands of years humans traveled on foot. For thousands of years humans used animals to ride or to pull vehicles. For the last 100 years humans have ridden in gasoline-powered vehicles. The efficiency with which this gasoline has been used has continuously increased, netting more person-miles and ton-miles to the gallon.

Alternatives to gasoline-powered vehicles are being developed. At some point, gasoline may go the way of the horse and drop out of contention as the main transportation power source. So saving petroleum or other substances that may be critical resources now in anticipation that they will be needed in the future may be unwarranted.

Conserving resources for the future may impose unnecessary constraints on progress. The long-term trend since the Industrial Revolution some 200 years ago has been one of increasing prosperity. Succeeding generations have been wealthier than preceding generations. Chances appear pretty good that later generations will be able to afford a higher standard of living than we now enjoy.

Consequently, requiring the poorer current generation to save more so that wealthier following generations will have more seems inequitable. The inequity is especially egregious when it comes to those currently living in poverty. "Sustaining" subsistence is far less tolerable than sustaining a life lived in the relative comfort of your typical American environmental activist. Many inhabitants of Third World countries depend on selling raw materials like petroleum. They depend on affordable fuel to help grow their economies. Measures that reduce the availability or increase the price of resources will be a lot harder on these poor people than on the affluent in the West.

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A second key concept of environmental alarmists is the so-called "precautionary principle." The idea here is that anything that entails any amount of risk is to be shunned or prevented from happening. According to this way of thinking, only when it is proven beyond a reasonable doubt to be safe should such a product or activity be permitted.

An example of the precautionary principle in action is the environmental alarmists' protest against genetically modified foods. Scientists can now use gene-splicing to engineer more favorable traits into food. "Golden rice" is one of the products developed by this technique. This genetically modified rice incorporates more vitamin A into the plant. The benefit of this is that it enables people whose diets are over-dependent on rice (as is the case in many Third World countries) to obtain sufficient amounts of this vitamin to ward off blindness. This is not to say that everyone who eats plain rice will go blind. However, a distressingly large portion of the children in Third World countries do go blind from insufficient quantities of vitamin A in their diets.

Despite the beneficial attributes of golden rice, it is still a genetically modified "Frankenfood" to many environmental alarmists. The gene-splicing necessary to create golden rice is unnatural. It could have unforeseen consequences. It would be better, argue advocates of the precautionary principle, to wait until it can be proven to be totally safe before its widespread introduction into the food supply.

It is easy for the affluent and well fed, who can supplement abundant food supplies with vitamins, minerals, and herbal nutrients, to be cautious about new, untried, genetically modified foods. No one is saying these people must eat these innovations. But it is not so easy for people living in constant danger of malnutrition to wait for more evidence that genetically modified foods are perfectly safe.

Further, the notion that genetically modified foods are a recent innovation ignores the thousands of years of human genetic "tampering" with nature that has produced many agricultural products we take for granted. There was never a time when the type of cows that produce our milk ran free and wild. Modern milk cows are the outcome of thousands of years of selective breeding that has modified the genetic make up of these creatures.

Hybrid Corn

A similar story can be told about the corn-on-the-cob we chow down on at picnics. American Indians nurtured this hybrid through cross-fertilization of carefully selected weeds. Or how about that pet Chihuahua at the end of your leash? Ever see a pack of them run down prey on one of those nature shows?

The fact is, people have been genetically modifying other living creatures for thousands of years. It's just that earlier methods were less predictable and more time-consuming than modern gene-splicing methods. We are doing what we have always done—changing the world to make it more to our liking.

The fact is, people have been genetically modifying other living creatures for thousands of years.

If the precautionary-principle zealots had walked among our cave-dwelling ancestors, they probably would have tried to prevent the use of fire. It's dangerous and polluting. It has killed far more people than nuclear energy—a modern substitute in many uses. Yet, even today, environmental alarmists oppose replacing coal-fired electricity with nuclear-generated electricity.

The precautionary principle takes a healthy skepticism about the new and untried (after all, most new ideas are a flop; only a minority ultimately succeed) and turns it into a stultifying phobia. Progress requires that we take calculated risks in the effort to make things better. The track record of science and technology in this regard should be a source of confidence. The human mind is an amazing tool. It ought not to be tied down by irrational fears.

A third key concept of the environmental lobby is that there must be "stakeholder participation" in important decisions. Transactions between buyers and sellers are deemed insufficiently participatory. Third parties would like to butt in and dictate different terms for the transactions.

In the marketplace buyers and sellers find each other and voluntarily enter into agreements to trade money for products or services. No one forces either party to

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trade. Either is free to refuse or back out of a transaction before it is consummated. Often buyers can return merchandise and get their money back if they are dissatisfied.

While it is legitimate to insist that the voluntary participants in market transactions not leave a mess for others to clean up (for example, smoke from the coal-fired power plant that sells electricity to business and residential customers), it does not necessarily follow that these others be given an equal or dominant voice in the terms of the transaction.

Consider the case of the pesticide DDT. There are many places in the Third World where DDT could save lives if it were used to combat malaria-carrying mosquitoes. An estimated two million deaths per year are attributed to malaria. Public-health workers in these afflicted areas are willing to buy DDT. There are companies willing to manufacture it. However, "stakeholders" from the environmental quarter have prevailed on governments to ban the trade in this product.

DDT was banned on the basis of its suspected contribution to thinning eggshells among wild birds. The forecast was for massive die-offs among birds leading to what the originator of this concern—Rachel Carson—said would be a "silent spring." There is no evidence that DDT is harmful to humans.

Saving wild birds is a worthy goal. If it can be done without endangering people, few would object. Saving wild birds at the cost of human lives, though, is much less defensible. From the security of an America that is largely safe from the ravages of malaria, the risk/reward trade-off from banning DDT might look acceptable. The trade-off is far less acceptable in regions where malaria is a major killer. The people living in these regions ought to be free to use DDT to save their lives. The intervention of the environmental "stakeholders" interferes with this freedom. (Fortunately, some attitudes have changed and the World Health Organization now sanctions some uses of DDT.)

Getting It Backwards

The environmental alarmists have it backwards. If anything imperils the earth it is ignorant obstruction of science and progress. People living on the edge of subsistence cannot afford to conserve the environment. Their energies must go into surviving. People who are prosperous can afford to think about conserving the environment. So to the extent that the measures demanded by environmental alarmists retard progress, they also endanger the environment.

That technology provides the best option for serving human wants and conserving the environment should be evident in the progress made in environmental improvement in the United States. Virtually every measure shows that pollution is headed downward and that nature is making a comeback.

People living on the edge of subsistence cannot afford to conserve the environment. Their energies must go into surviving.

A few years ago I visited the historical site of "the shot heard round the world"—Lexington, Concord, and Battle Road in Massachusetts. The area is lush with trees and greenery. Park Rangers explain that in 1775 the area was void of this greenery. The trees were chopped down to make way for farming. In those days farming was so much less efficient than today that 80 percent of the population had to engage in it to provide enough food to feed the nation. Vast swaths of countryside had to be leveled for the low-yielding crops of that era.

Technology has changed all that. Pesticides and genetically modified crops have allowed more of the fruits and vegetables to escape being eaten by insects. Better transportation has enabled more food to get to market before spoiling. Refrigeration has allowed food to stay edible longer. As a result, the portion of the workforce needed for agriculture has dropped to 2 percent. Massachusetts farmland has been allowed to revert to forest.

This is the model for saving the rest of the planet: let freedom to think and trade make use of the genius of humanity for a better world.

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Cool on the Idea of Cooling Global Warming

BY DONALD J. BOUDREAUX

Here's some self-promotion: the December 21, 2006, issue of *The New York Review of Books* published this letter of mine—a letter saturated with the obvious influence of FEE's founder, Leonard Read:

> I've read few passages in your pages that are as mistaken as Bill McKibben's assertion that "the technology we need most badly is the technology of community—the knowledge about how to cooperate to get things done. . . . We Americans haven't needed our neighbors for anything important. . . ." ("How Close to Catastrophe?," *NYR*, November 16.)
>
> Each of us cooperates daily with countless others—neighbors, fellow citizens, foreigners—to ensure not only our prosperity but our very existence. My mind boggles at the number of people who cooperated to make available to me, for example, the shirt on my back. Cotton growers in Egypt; fashion designers in Italy; textile workers in Malaysia; merchant marines from around the globe; investment bankers in Manhattan; insurers in Hartford; truck drivers along the East Coast; department store executives in Seattle; security guards and retail clerks in Virginia—these people and millions of others cooperated so that I might wear an ordinary shirt. Ditto for my house, my food, my subscription to *The New York Review of Books*.
>
> For McKibben to say that "cheap fossil fuel has allowed us all to become extremely individualized, even hyperindividualized" is to be blind to the amazing and vast system of cooperation that today spans the globe. Clearly, we have, in spades, "knowledge about how to cooperate to get things done."

Bill McKibben responded:

> Donald J. Boudreaux's response proves precisely the point I was trying to make—and it says something about the blinders that too many economists have strapped on. We do cooperate, unconsciously, to promote our individual self-interest; Chairman Boudreaux's slightly less elegant restatement of Adam Smith's remarks about the butcher and the baker are [sic], as far as I can tell, not in serious dispute. What is in dispute is whether this cooperation carries over into more crucial matters—like keeping the planet from overheating in the next decade. Since my article came out, the British government has released a report estimating that the economic cost of global warming will exceed the combined impact of both world wars and the Great Depression of the 1930s. So far, there is precious little sign of our communities coming together to meet this challenge—politically, economically, culturally. Which doesn't prove Smith—or even Boudreaux—wrong. Just incomplete.

I wonder if Mr. McKibben really believes that keeping the planet from overheating in the next decade is "more crucial" than is cooperation within markets. If he truly holds this belief, then he doesn't begin to appreciate how marvelous are the everyday achievements of markets and how utterly dependent we all are on the continuation of this cooperation. Put simply, without this cooperation, billions of us would soon die. Without the food, clothing, shelter, sanitation, and medications that this global cooperation produces *daily*, only a tiny fraction of those of us now breathing would still be breathing three or four years from now. And none of us, even those who manage to stay alive, would live as comfortably, as cleanly, and as securely as we live today. This fact is true regardless of how important it is to save the planet from "overheating" between now and 2017.

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Even if we assume that global warming will cause massive damage—even if we accept as inevitable the National Resources Defense Council's "worst-case scenario" that "global warming could make large areas of the world uninhabitable and cause massive food and water shortages, sparking widespread migrations and war"—saving the world from global warming clearly is not *more* crucial than maintaining the vast division of labor and market-inspired cooperation that spans the globe.

McKibben's and many other environmentalists' failure to understand that markets bring us not only prettier trinkets and more convenient appliances but also the means with which we maintain our very lives leads these persons to discount the market's importance to humanity. They see only capitalism's (real or imagined) costs and are blind to its indispensability. This blindness, in turn, causes many environmentalists to endorse policies that, in fact, would likely kill and impoverish many more people than would be killed and impoverished by global warming or other (real or imagined) threats to the natural environment.

This blindness of environmentalists—often borne of a mindless, romantic adoration of nature—underpins the reluctance of those of us who recognize the true significance of capitalism to yield power to governments to tackle global warming. We worry that this power will kill the goose that's laying our golden eggs.

Exaggerated Worry?

If you think that such a worry is exaggerated, recall that it's not only globe-trotting anti-commerce intellectuals such as Bill McKibben who want capitalism to be severely reined in. In his book *Earth in the Balance*, former U.S. Senator and Vice President Al Gore asserted that we are suffering an "environmental crisis" that can be avoided only if we "drastically change our civilization and our way of thinking."

"Drastically change our civilization"?! Scary stuff. Gore wants us to scale back significantly our reliance on markets, trade, and industrial activities in order to lessen our "footprint" on the earth. We can, no doubt, make our environmental footprint much smaller, but how great a benefit will this achievement be if it returns us to the ages-old condition of high mortality and high morbidity?

Undoubtedly, most people who seek government action to fight global warming are not Rousseauian romantics in the mold of Bill McKibben or posturing politicians such as Al Gore. Most people are "reasonable." They envision no drastic changes to our civilization, just a marginal tempering of industrial activity that results in marginal improvements in the natural environment's future prospects. And I concede that cost-effective steps to reduce global warming might, in principle, be possible at the margin. But I'm sure that it's also true that most of the "reasonable" people who demand action against global warming are unaware of just how critical is the role that capitalism plays in improving the lives of ordinary men and women.

I also worry that when "reasonable" people empower government to "solve" the global-warming problem, the risk is high that anti-commerce environmentalists will form an alliance with politicians and bureaucrats who welcome excuses to boost their power. Such an unholy alliance will consistently exaggerate the magnitude of the problem and understate the costs of "solving" it.

Given the widespread ignorance of the benefits of capitalism along with political realities and the hysterical language used by the likes of Al Gore—who, let's be clear, is not on the fringes of the U.S. power structure—it's a perfectly legitimate stance for truly reasonable people to conclude that the best policy regarding global warming is to neglect it and to let capitalism continue its uninterrupted history of making us healthier and wealthier.

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Welfare for the Rich

BY ROBERT P. MURPHY

Advocates of the free market—including those considered "right-wing" and "conservative"—believe it is wrong to violate property rights. Consequently, they oppose egalitarian measures to steal from the rich and give to the poor. Such "income redistribution" represents naked theft and epitomizes the Founding Fathers' fears of unfettered democracy. At the same time, champions of laissez faire devote much of their time to criticizing the thousands of distortionary and punitive regulations imposed on businesses. Indeed, Ayn Rand went so far as to write an essay in which she described big business as "America's persecuted minority."

In light of these tendencies, it is easy to overlook the fact that a large portion of the welfare state is devoted to *the rich*. Although couched in altruistic language and billed as serving the public interest, much of the government's redistribution of wealth is from the hapless taxpayer to the pockets of large corporations. This may seem paradoxical to naïve observers whose political views are shaped largely by political campaigns between Democrats (the ostensible friends of the poor) versus Republicans (the ostensible opponents of welfare). But anyone familiar with political economy can quickly recognize that it makes far more sense for politicians to funnel tax dollars into the hands of powerful (not to mention rich) special interests. Big business learned long ago that the easiest way to handle taxes and regulations is to divert "public" money into its own hands and to influence the regulators to enforce measures that disproportionately burden upstart competitors.

I hope to redress the rhetorical imbalance by outlining the numerous ways rich individuals and big businesses manage to siphon off taxpayer money into their own pockets. To keep the article manageable, I'll focus mainly on actual subsidies, that is, cases where wealthy rent-seekers literally receive cash flows (directly or indirectly) from the government. Beyond these fairly obvious examples there are dozens of clever ways in which rich and unscrupulous special interests use their political influence to enrich themselves at the expense of the public without actually receiving tax dollars. (These include licensing restrictions and import quotas.) Because of space constraints, an extensive analysis of these subtler shenanigans will have to wait for a future article.

One of the most blatant examples of corporate welfare is the bloated system of agricultural price supports, which started in the 1920s and was institutionalized during the New Deal. The rationale behind the program is straightforward: Under pure laissez faire, agricultural markets would (allegedly) prove extremely volatile. In good times with high prices farmers would borrow money to expand their operations and plant more crops. But this would soon lead to a glut on the markets, forcing farmers to slash prices and go into foreclosure. This tremendous uncertainty, as well as the wild swings in crop supply, could (allegedly) be rectified if the federal government stepped in to purchase surplus crops when the market's demand proved insufficient. Such policies would presumably stabilize crop prices and the food supply, providing more rational and orderly markets in agriculture.

As with other forms of government intervention, a pure policy of surplus acquisition would lead to disaster. If farmers were assured that whatever quantity of a crop they grew the government would buy it from them

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at remunerative prices, they would plant the most cost-effective crops with reckless abandon. (Indeed, at the close of 2000 the Commodity Credit Corporation [CCC], a branch of the U.S. Department of Agriculture, held stockpiles of 97 million bushels of wheat, eight million bushels of corn, and five million bushels of soybeans, according to the Food and Agricultural Policy Research Institute. The CCC spent $133.5 million to purchase over a million metric tons of wheat on a *single day* in 1999.) To avoid the accumulation of stockpiles and yet maintain price supports for certain crops, the government hit on the absurd notion of paying farmers *not* to grow the crops in question. It is possible to qualify for such subsidies even if an owner of arable land had never intended to grow the crops in the first place.

From 1995 to 2004 the federal government provided agricultural subsidies of over $143 billion, according to the Environmental Working Group. The recipients of these subsidies are not exactly Dust Bowl migrants from a Steinbeck novel, either. Over $104 billion (72 percent) of the loot during this period went to the top 10 percent of the recipients, which were large farming organizations or cooperatives that each received an average of $33,000 in subsidies every year. To further illustrate the phenomenon, in October 2005 the House Agricultural Committee rejected a proposal by President Bush to place a cap on annual farm subsidies of $250,000 *per person*.

Another classic example of how the well-to-do fleece the taxpayers is the multiplicity of "joint ventures" between the government and big business. Projects such as sports stadiums, railroads, or even amusement parks are deemed "too big for the private sector." Besides being silly—after all, any money that the government spends on such projects was taken *from* the private sector—these pork-barrel expenditures represent a transfer from the poor (and middle class) to the rich.

For example, the fiscal 2006 Transportation/Treasury/Housing and Urban Development (TTHUD) Act contained $350,000 for the Yucaipa Valley Regional Sports Complex (in California) and $100,000 for renovations to the National Orange Show Stadium in San Bernardino. The Act also contained $50,000 for the Capitol Hill Baseball and Softball League. Beyond its support for sports fans, the government also subsidized art lovers and conference attendees (not typically drawn from the downtrodden of society). Citizens Against Government Waste points out that this same Act contained $325,000 each for renovations to the Seattle Aquarium and the Fox Theater, $200,000 for renovations to the Fredonia Hotel and Convention Center in Texas, and $100,000 for D.C.'s Friends of Carter Barron Foundation for the Performing Arts.

These anecdotes, though outrageous, are whimsical when compared with other types of corporate welfare. For example, the federal government provides enormous funding for energy research, which attempts to develop alternative supplies and technologies as well as discover better methods of using existing sources. The Cato Institute estimates that in fiscal year 2003, the Energy Department spent $670 million on such projects. Inasmuch as struggling single mothers are not designing ethanol engines, this largess represents yet more welfare for the rich.

In a similar vein, the government spends billions funding scientific research. In FY2005 the National Institutes of Health alone spent over $24 billion on all awards, and over $20 billion of this consisted in research grants. Large pharmaceutical companies certainly benefit from this convenient assistance.

We close this section with the epitome of a failed government/business partnership, the classic case of Amtrak. In 2005 alone Amtrak lost $1.2 billion, according to the Heritage Foundation, a shortfall made up by the hapless taxpayer. What makes this waste even more despicable is that Amtrak doesn't even fulfill its ostensible purpose, namely, to provide affordable passenger rail service across the nation. In particular, Amtrak doesn't offer service to Phoenix, Las Vegas, Columbus, Nashville, Louisville, Dayton, Tulsa, or Colorado Springs, even though each of these cities has over 500,000 residents. And as anyone who has ridden Amtrak knows, it is far from cheap. For example, its cheapest roundtrip fare from New York City to Washington, D.C., is currently $135 before taxes, compared to $69 for a similar ticket on an admittedly slower bus.

Government Contractors

Even government projects that might be deemed legitimate—such as expenditures on military vehicles or renovations to the Statue of Liberty—represent

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hidden subsidies to the extent that the contracts are awarded corruptly. The economic principles behind the cost overruns are straightforward enough. Unlike the shareholders of a private firm, if government departments are careful to award contracts to the lowest bidder (who can still get the job done), the politicians and bureaucrats don't pocket the savings, for that would be sheer theft of public funds. On the other hand, by awarding generous contracts, officials stay in the excellent graces of the beneficiaries. This comes in handy when officials retire from government work and look for consulting jobs.

Another source of systematic welfare is the "cost-plus" method of payment. Here, the government doesn't settle on an actual price for goods or services delivered, but rather agrees to meet the contractor's expenses plus some markup. Naturally, this type of arrangement puts no incentive on the contractor to watch costs, and hence represents a hidden subsidy.

We should also consider the effect of timing and the different outcomes in private versus government settings. Congress can agree to spend, say, $20 billion on a space station that will take ten years to complete. Five years into the contract the suppliers can complain that they will require an additional $10 billion to finish the project because of "unexpected" expenses. By this point the voters don't remember the previous expenditures, and it would seem a terrible waste not to finish such a grand project. Thus the government often ends up funding boondoggles that would never have been approved had the actual price tag been known all along.

When it comes to welfare for contractors, no other agency can match the Pentagon, with its classified programs and aura of necessity. Besides the notorious $600 toilet seats uncovered in a 1983 audit, probably all the major purchases of hardware occur at inflated prices. (The difference is, nobody knows how much a B-2 Stealth bomber "should" cost, so its 2001 price tag of $530 million isn't as shocking.) No outsider can really be sure of the exact amount of the hidden subsidy, or what the corporate beneficiary does to win it, but we *can* be fairly sure that the recipients do not reside in the inner city.

On this topic we must mention the case of Halliburton, for this is one issue on which the leftist conspiracy theorists make a decent case. Regardless of the motivations for the invasion of Iraq, it cannot be denied that Halliburton benefited greatly from it. According to a report by the Center for Public Integrity (which required six months and 70 Freedom of Information Act requests to assemble the data), Halliburton received over $2.3 billion in reconstruction contracts in Iraq and Afghanistan. In second place was the engineering and construction firm Bechtel Group, Inc., with just over $1 billion. International American Products, Inc., finished third with a nonetheless-respectable $526 million in contracts. (For those interested in conspiracies, Halliburton and Bechtel contributed roughly $2.38 million and $3.3 million to President Bush, respectively, while International American Products only contributed $2,500.)

The "War on Terror" has been a bonanza for defense and related contractors. According to Robert Higgs, Department of Defense outlays *excluding* payments to military personnel rose from $217 billion in FY2001 to $366 billion in FY2006. In this same period the number of companies with federal homeland-security contracts grew from nine to a whopping 33,890, a jump so large that it renders typical percentage figures—in this case, a growth of 376,456 percent—rather meaningless.

Small Business Administration

The Small Business Administration (SBA) is another agency with an apparently noble mission that nonetheless acts in reverse-Robin Hood fashion. In 2005 the SBA announced that $79.6 billion in federal contracts were awarded to "small businesses." However, according to the *New York Times*, some of this money went to mom-and-pop organizations such as Northrop Grumman, Boeing, Bechtel, and General Dynamics. Indeed, the *Christian Science Monitor* reports that almost $5 billion of the contracts classified as "small business" were for the 13 largest government contractors.

Beyond winning contracts theoretically intended for small businesses, there is another way big business benefits from the SBA. In a scheme that Doug French (himself a Las Vegas banker) calls "welfare for bankers," the SBA guarantees loans for qualifying businesses. Banks are then able to pool such loans and sell them in secondary markets. Now in a simple model of perfect competition, the SBA guarantees would benefit only the loan recipi-

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ents, because they would acquire funding at lower interest rates. But in the real world, savvy banks acquire "PLP status," meaning they are preferred lenders. This allows them to issue SBA-guaranteed loans without as much paperwork and other hassles as other banks would need to suffer, and so allows these privileged banks to earn a net income from the entire process. To the extent that PLP status represents a hurdle that has nothing to do with merit or business performance, the process is a form of subsidy to certain (rich) bankers.

The Government National Mortgage Association (GNMA or "Ginnie Mae") is a public corporation in the Department of Housing and Urban Development. Ginnie Mae boosts the secondary mortgage market by guaranteeing principal and interest payments on mortgage-backed securities. In a typical case, a bank or other institution will acquire dozens of individual mortgages from homebuyers and place them into a single pool, then issue securities to other investors based on the cash flows from the mortgage payments. In the event of unexpected defaults by the homebuyers, Ginnie Mae would step in to guarantee the payments to the secondary investors.

This pledge obviously makes the guaranteed securities more attractive, lowering their promised rate of return. This in turn lowers the mortgage rates faced by the original homebuyers, but also provides liquidity in the secondary mortgage market and no doubt higher commissions for politically savvy middlemen. (As Ginnie Mae's Wikipedia entry puts it in an unintentionally humorous line, "This arrangement seemingly benefits everyone involved.") Naturally the loser is, as always, the U.S. taxpayer, who must assume the losses from mortgage loans made at rates that do not reflect the true risks involved. Although in recent years Ginnie Mae has itself earned more in service fees than it paid out on defaults (and thus did not use any public funds), this is only possible because the taxpayers are ultimately liable for the outstanding collection of guaranteed mortgage-backed securities: total potential exposure in 2004 was $453.2 billion.

Other Guarantees and Bailouts

The same analysis applies to other government loan guarantees. For example, suppose the federal government guarantees that it will make good on bonds issued by the Mexican government in the event of a default. Such a pledge undoubtedly showers benefits on both the Mexican government and the (typically wealthy) investors in its bonds, while the source of these benefits is undoubtedly the American taxpayer. This is true even if the Mexican government does *not* default on its bond payments. After all, if the taxpayers pledged to pay all costs associated with a fire at any of General Motors' factories, this would certainly be a subsidy to GM, even if no such fire ever occurred. (This is obvious; with the federal guarantee, GM would save the money it otherwise would have spent on fire-insurance premiums.) In a similar fashion, even if the Mexican government doesn't default, it still benefits from borrowing money at lower interest rates than would otherwise be the case.

Of course, if and when the U.S. government has to make good on these types of pledges, the transactions involve funneling taxpayer dollars to wealthy investors both at home and abroad. Sometimes these subsidies are particularly subtle. For example, during the Mexican "peso crisis" of 1994, the Clinton administration contributed some $20 billion to the international bailout effort by providing loan guarantees and currency swaps. This latter move, executed by the Treasury's Exchange Stabilization Fund, swapped cash flows denominated in dollars with those denominated in pesos. Inasmuch as the dollar flows originated (at least partly) with the government Fund, and also because the whole purpose of the intervention was to engage in currency swaps that the private market considered unprofitable, President Clinton's decision used U.S. tax dollars to shield the Mexican government from its irresponsible monetary policies. In short, yet another example of welfare for the rich and powerful.

The celebrated fate of Long Term Capital Management (LTCM), a huge hedge fund that had Nobel laureates Myron Scholes and Robert Merton on its board, presents yet another case of corporate welfare. Because its trading strategy took advantage of slight (but theoretically "irrational") overvaluations of newly issued bonds (versus older "off-the-run" bonds), LTCM was highly leveraged, sometimes with a leverage ratio of over 30. When the Russian government defaulted on

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its bonds in 1998, this set in motion a chain of events that proved catastrophic to LTCM's positions. In the course of a few months the amazing success story had lost over $4.6 billion. Citing the potential disruptions to the entire financial community if LTCM itself defaulted, the New York Federal Reserve Bank intervened. Though it technically did not use public money in the bailout, the Fed nonetheless used "moral suasion" (backed perhaps by implicit pressure?) to get LTCM's major creditors to allow for an orderly liquidation. Supporters of the move claimed that it prevented a financial meltdown, while critics pointed out that the "too big to fail" mentality would only encourage large institutions to take risky positions in the future, and that the ultimate fallback to the government-sponsored rescue allowed LTCM to reject a private-sector bailout effort led by Warren Buffett. (Under Buffett's plan, the managers of LTCM would have been fired and the shareholders would have fared much worse than they did under the "necessary" Fed-brokered arrangement.)

We cannot leave this section without mentioning the post-9/11 federal bailout of the airlines. The Air Transportation Safety and System Stabilization Act (signed on September 23, 2001) gave $10 billion in loan guarantees, as well as $5 billion in direct "relief," to the airlines. Now even libertarians may differ on the justification for this bailout. After all, the federal government hampered the ability of the airlines to prevent 9/11 (through gun bans and other interventions) and also forced them to lose business by the mandatory flight ban immediately after the catastrophe. Nonetheless, the entrepreneurs involved in the airline industry certainly did not live up to their task of anticipating the future better than others. In a truly free market the consequences of poor preparation are losses. When the critics ask, "If the free market is so good, why did the government need to take over airline security?" the defender of laissez faire can reply, first, that government was involved in security before 9/11 and, second, that airline executives did not actually face the full pressures of the profit-and-loss test. When their inadequate security measures allowed disaster, they didn't bear the full brunt of these shortsighted decisions.

Government Deficits and the Federal Reserve?

Though not as clear cut as some of the other examples in this essay, the annual issuance of hundreds of billions of dollars in new government bonds may qualify as welfare for the rich. If one agrees that the federal guarantee of Mexican bonds represents goodies to the wealthy at the expense of the taxpayer, then by consistency one must also condemn massive federal deficits for the same reason. This is because *all* Treasury bonds are "guaranteed" by the full faith and credit of the U.S. government as a matter of course. This practice allows the Treasury to obtain loans at low rates of interest and undoubtedly showers income on politically connected banks and other financial brokers. As always, the losers are the taxpayers (who must ultimately pay off the Treasury's debts) and the smaller banks that do not enjoy the privileges of Fed membership.

When it comes to the "moral hazard" of federal relief, the standard illustrations are the Federal Deposit Insurance Corporation and federal checks to property owners after natural disasters, such as hurricanes and earthquakes. By insuring checking deposits (up to $100,000), the FDIC provides an incentive for banks to invest in riskier projects because on the margin the (expected) costs of doing so are reduced. In a similar manner, when the government provides massive relief to owners of beachfront condos and hotels after a hurricane, this encourages more development in disaster-prone regions than would otherwise occur (if the owners had to pay full market insurance premiums). To the extent that owners of banks and beachfront property tend to be above-average income earners, these programs represent yet more examples of subsidies to the rich.

The final example we shall discuss is one of the most blatant and economically unjustified: the Export-Import Bank. It is worth quoting the Bank's own mission statement in its entirety:

> The Export-Import Bank of the United States (Ex-Im Bank) is the official export credit agency of the United States. Ex-Im Bank's mission is to assist in financing the export of U.S. goods and services to international markets.

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Ex-Im Bank enables U.S. companies—large and small—to turn export opportunities into real sales that help to maintain and create U.S. jobs and contribute to a stronger national economy.

Ex-Im Bank does not compete with private sector lenders but provides export financing products that fill gaps in trade financing. We assume credit and country risks that the private sector is unable or unwilling to accept. We also help to level the playing field for U.S. exporters by matching the financing that other governments provide to their exporters.

Ex-Im Bank provides working capital guarantees (pre-export financing); export credit insurance; and loan guarantees and direct loans (buyer financing). No transaction is too large or too small. On average, 85% of our transactions directly benefit U.S. small businesses.

With more than 70 years of experience, Ex-Im Bank has supported more than $400 billion of U.S. exports, primarily to developing markets worldwide.

As with most descriptions provided by the agencies themselves, the Ex-Im Bank's statement seems innocuous enough. Yet Henry Hazlitt, in his wonderful *Economics in One Lesson*, long ago exploded the myth that subsidizing exports is good for the economy. For example, when the Ex-Im Bank "levels the playing field" by "matching the financing that other governments provide to their exporters," what does this really mean? It means that the federal government gives money to foreign governments or companies which they then use to purchase products from American exporters. To clearly see what is going on, it would be simpler if the U.S. government first bought the products from domestic producers (using tax dollars, of course) and then *handed them over for free* to the foreign organizations. Yes, this practice benefits the workers and shareholders of the privileged exporting firms, but these gains are more than offset by the losses to the taxpayers. After all, as Hazlitt pointed out, the country as a whole doesn't get rich by giving goods away.

Similar to the Ex-Im Bank is foreign aid in general, to the extent that the recipient governments spend the money on U.S. exports. For example, according to the Cato Institute, in FY2003 $3.7 billion in federal money was used to finance weapons purchases for foreign governments.

Free-market enthusiasts often rail against welfare for the poor, and rightly so. However, as both experience and political economy suggest, the welfare state also redistributes wealth into the hands of the rich and politically powerful. To offer a consistent message—as well as attract support among more-egalitarian observers—advocates of laissez faire should condemn the billions of dollars in annual subsidies for the rich.

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The Struggle to Subdue Luck

BY ANTHONY DE JASAY

There was a time in Western societies under the rule of law when a person's circumstances, such as his relative position in society, could only be branded as unjust if they could be shown to result from some breach of the rules of justice. The rules were enshrined in ageless conventions and elaborated in common or civil law. It was a recognized fact of life that without any breach of the rules, some would succeed in life far better than others and being rich or being poor was not in itself evidence of injustice.

Such a view was in harmony with a laissez-faire economy and with the idea that the state has a duty to protect the inviolability of property. Obviously, it also represented a blunt denial of the legitimacy of redistribution.

Modern democracy must use redistributive offers to assemble majorities and could ill afford to admit that such practices are illegitimate. Therefore the classic view, "There is no injustice without unjust acts causing it," had to go. For a while "social justice" was invoked to replace it. Unlike justice *tout court*, social justice has no rules that can be either kept or breached. Therefore one can never tell that a state of affairs is "socially just." But it can always be made more just by adding another piece to the welfare jigsaw puzzle that has been fashioned by a redistributive past. Social justice is a very useful idea because it dresses naked political expediency, or egalitarian passion, in the dignified cloak of justice. Doctrinally, however, it is pitifully vacuous. It badly needs to lean on some intellectually more appealing and coherent theory.

The badly needed intellectual underpinning of redistribution is nourished by two separate sources. One is the idea that society survives and multiplies best when it functions as a mutual insurance scheme. Under it the victims of random events—an earthquake, a drought, a fire or a flood—in one part of the country are compensated by the rest who have been spared, and all survive. The scheme supposedly descends to us from our hunter-gatherer ancestors, among whom the lucky hunter shared his booty with the unlucky ones. Next time they would share theirs with him. The scheme has compelling logic when the booty is perishable, but becomes controversial when it can be stored and especially if it is always the same "hunters" who have the luck and must share with the others.

Above all, the scheme is a slippery slope. Initially only catastrophe victims are compensated. But if the victim of a flood is entitled to compensation, why should the victim of a flood of cheap Chinese textile imports not be compensated?—not to speak of the victims of technological progress, the victims of a change in consumer tastes, the victims of a restrictive monetary policy. Clearly, there will always be too many victims claiming compensation for too many events that are far from random, and the scheme will not be a mutual one because it will always be broadly the same group of people who will carry the burden of compensating the others. What masquerades as mutual insurance for mutual benefit is in fact plain redistribution without the legitimacy of a veneer of justice.

The second of the two sources of the contemporary theory of what we might call "justice without rules" supplies the missing element. Put plainly, it holds that justice must be understood as fairness, and as luck is intrinsically unfair, it must be subdued. A person's inher-

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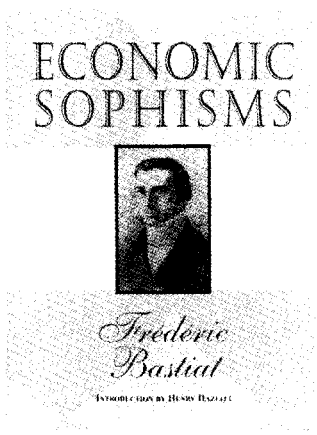
ited or acquired abilities, character, and possessions, his capacity and will to gain knowledge and make efforts, are all lucky endowments that are "morally arbitrary" because he has not positively deserved them. Likewise, a person who has only few such endowments has not done anything to deserve being so poorly endowed.

The theory tells us that if all these people are to agree on a set of just social institutions (including the taxation of income and wealth), they must negotiate them behind a "veil of ignorance." This means that they must totally lose all knowledge of their own endowments. Devoid of particular endowments, everybody is exactly the same as everyone else. No one has an unfair advantage conferred by good luck, nor disadvantage due to bad luck. Since no one knows whether in real life he is clever or dumb, lucky or unlucky, all will vote for a society where inequalities are ironed out. The effect of luck is drained from the system because people in a state of fairness agree to devise institutions that subdue luck.

It is arbitrary, but not quite absurd, to claim that an undeserved advantage is unfair. But it is absurd, and a plain mistake of language and logic, to affirm that what is not deserved is undeserved. Between what is deserved and what is not, there is an immense range of conditions that are morally neutral, neither deserved nor undeserved, but simply facts of life.

But this mistake is as nothing compared to the truly frightening blunder of requiring society, in the service of "social justice" or (to use the slightly less confused term) "distributive justice," to go to war against the most elementary and powerful facts of life and to subdue luck. Societies that tried even half-seriously to do this—the late lamented Soviet Union springs to mind—have collapsed under the effort. Mature welfare states that go some way down this road are half-crippled by the burgeoning expense.

Luck is a very mighty adversary, and it is a grave mistake to enlist justice to fight it.



Economic Sophisms

By Frédéric Bastiat

Introduction by Henry Hazlitt

Although written 150 years ago, Bastiat's devastatingly accurate attacks on the illogical, self-serving arguments of protectionists remain both relevant and entertaining. Among the gems in *Sophisms* are "The Negative Railroad," "Petition of the Candlemakers," and "The Physiology of Plunder."

Perhaps the best recommendation for *Sophisms* comes from renowned journalist and FEE founding trustee Henry Hazlitt. In his introduction to the book, Hazlitt declares:

We could use more Bastiats today. We have, in fact, desperate need of them. But we do, thank Heaven, have Bastiat himself, . . . and the reader of these pages will not only still find them, as Cobden did, "as amusing as a novel," but astonishingly modern, for the sophisms he answers are still making their appearance, in the same form and almost in the same words, in nearly every issue of today's newspapers.

Published by the Foundation for Economic Education — 328 pages, paperback

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"Congressional Generosity"

BY SHELDON RICHMAN

Every now and then we get a glimpse into what government officials really think about our rights to life, liberty, and property. The U.S. Justice Department recently provided such a glimpse in a controversial tax case, *Murphy v. IRS*.

How revealing it is! Did you know that if the government abstains from taxing *all* your income, you should be grateful for this "congressional generosity"?

To recap the case, Marrita Murphy was awarded $70,000 in compensatory damages for the mental distress and loss of reputation she claimed to have suffered after she acted as a whistleblower against her employer, the New York Air National Guard. She paid about $20,000 in federal income taxes on that money, but later asked for a refund on grounds that the damage award should have been excluded from her gross income under §104(a)(2) of the Internal Revenue Code (Title 26 of the U.S. Code), which states: "gross income does not include—. . . (2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness . . . ."

The IRS rejected the request because her injuries were nonphysical and the section specifies "physical injuries." When she sued in federal district court she lost.

Murphy appealed to the U.S. Court of Appeals for the District of Columbia Circuit. She argued that the compensation was covered by §104(a)(2) but if not, then the section is unconstitutional because it would permit the taxation of money that is not included in the constitutional and statutory meaning of "income."

The government rebutted that Murphy's injuries were *nonphysical*—and hence not included in §104(a)(2)—and that IRS policy was consistent with the concept of "income" as used since the Sixteenth Amendment was ratified in 1913.

In August a three-judge panel stunned the government by ruling in Murphy's favor that §104(a)(2) is *unconstitutional*: "[T]he framers of the Sixteenth Amendment would not have understood compensation for a personal injury—including a nonphysical injury—to be income." (Point of historical fact: the Amendment did not delegate to the government the power to tax wages and other income. Under the Constitution, it *always* had that power.)

In October the Department of Justice petitioned to have the case heard by the circuit court's entire complement of judges (en banc). However, before the court could rule on the petition, the original three judges announced they would rehear the case themselves. The case was to be reheard this month.

The petition is revealing—and chilling. The Justice Department's task in the petition was to convince the court that the judges had defined "income" too narrowly, allowing them to exclude compensation for nonphysical injury from gross income. The judges had ruled that compensatory damages for injuries are intended to make a victim whole—that is, to restore something that is not taxable. Since the damage award was not a replacement for something taxable, such as wages, the judges said, the award itself should not be taxable.

What is ominous about the petition is how broadly the Justice Department views the government's power to tax. Unfortunately, the Department has the Constitution and a long line of cases to back up its position.

Here's a sample of what the Justice Department argued (internal quotes are from previous court opinions, citations are excised, and all emphasis is added):

"Congress's power to tax income, like its power to levy non-direct taxes generally, is indeed '*expansive*.' In Brushaber [v. Union Pacific Railroad, 1916], the Supreme Court emphasized that Congress's taxing power is '*exhaustive and embraces every conceivable power of*

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taxation.' It referred to the constitutional limitations as 'not so much a limitation upon the *complete and all-embracing authority to tax*, but in their essence [ ] simply regulations concerning the mode in which the *plenary power* was to be exerted.' "

"In [Commissioner v.] Glenshaw Glass [1955], the Court reviewed the '*sweeping scope*' of the predecessor to §61(a) [the beginning of the section of the law defining "gross income"] and observed that it had 'given a liberal construction to this broad phraseology in recognition of the *intent of Congress to tax all gains except those specifically exempted*.' The Court held that income includes 'undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.' "

The Department's petition proceeds to quote earlier court opinions on the broad range of the government's power to tax, for example, "We have repeatedly emphasized the '*sweeping scope*' of [§61, the code section that defines gross income] and its statutory predecessors" and "[Income] *extends broadly* to all economic gain not otherwise exempted."

The government's petition also emphasizes that the decision *not* to tax something belongs to Congress—and Congress alone:

"Any determination to exclude such damages from income is not required by the Constitution or driven by tax considerations, but is one of policy based upon value judgments. . . . Such determinations are the sole province of Congress, and . . . Congress established its clear intent to tax the type of award (for nonphysical damages) taxpayer here received."

In this connection, the petition quotes a 1996 Supreme Court case, *O'Gilvie v. U.S.*, which attributed the exclusion from gross income of compensatory damages for personal injury to—"*congressional generosity*"!

The petition closes with the Justice Department's claim that even if the damage award is not construed to be income "within the meaning of the Sixteenth Amendment," *the government may still tax it*:

"[T]he constitutional restrictions on Congress's taxing power deal only with how to tax, not what to tax. To conclude that the tax here is unconstitutional, the panel had to determine that it is either a direct tax requiring apportionment, or an indirect excise that is not uniform. . . . The panel wholly failed to perform this critical part of the analysis."

To boil the petition down to the fewest words: Congress may tax whatever it darn well pleases, thank you. If it abstains from taxing a type of revenue (be it income or not), just be thankful for its generosity. But don't go thinking you have a right *not* to have it taxed.

Political officials may talk a low-tax, limited-government game, but let a judge suggest there's something they *can't* tax and they show their true colors.

To be sure, Murphy's attorney, David Colapinto, responded to the petition. (All the documents are online at www.kkc.com/major_cases.jsp.) He too is able to cite Supreme Court cases but in support of Murphy's position that the three appellate judges were correct.

The Constitution Doesn't Interpret Itself

Eventually the Supreme Court will pick the winner. But it would be a mistake to think there is an objectively "right" answer. In the constitutional game, "right" (in the sense of what gets enforced) is whatever the courts decide. Constitutions and laws don't interpret themselves. People interpret them.

As Georgetown University law professor John Hasnas has written, "Because the legal world is comprised of contradictory rules, there will be sound legal arguments available not only for the hypothesis one is investigating, but for other, competing hypotheses as well."

We really have no reason to be shocked by the government's extravagant claim because we were warned 220 years ago. In 1787 the Anti-federalist Robert Yates ("Brutus"), objecting to Congress's power to tax under the proposed Constitution, wrote, "[T]his power therefore is neither more nor less, than a power to lay and collect taxes, imposts, and excises at their pleasure; not only the power to lay taxes unlimited, as to the amount they may require, but it is perfect and absolute to raise them in any mode they please."

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Miners, Vigilantes, and Cattlemen: Property Rights on the Western Frontier

BY ANDREW P. MORRISS

As Americans moved west over the course of the nineteenth century, the property-rights institutions they brought with them from the east evolved to meet the demands of the new conditions. The western frontier experience both changed and strengthened those institutions. The story of property rights on the frontier is captured by the experiences of three groups: the miners, the vigilantes, and the cattlemen.

Miners

When gold was discovered in California in 1848, just days before the territory was transferred by Mexico to the United States, what had been the Mexican province of Alta California had few inhabitants and little government. Located far from Mexico City and the centers of power in Mexico, Alta California's economy focused on the hide and tallow trade between the California ranchers and passing sailing ships. Property boundaries were poorly delineated, both because Mexican law allowed "floating land grants" whose precise boundaries were to be located later and because land in California was rarely worth the cost of completing the grant process and securing full title to a specific parcel. Moreover, the government of Alta California during the 1840s had distinguished itself primarily by its corruption, with several governors spending much of their time drawing up large grants of dubious legitimacy to award to friends and family members.

When control passed to the United States, only a small military force was present in the territory and Gen. Bennett Riley, the officer in charge, quickly made clear that he considered himself lacking in jurisdiction over civil matters. Moreover, Congress took no action

Early gold mining in California

to organize a government for the new territory because of an inability to agree on whether the new territory would be slave or free. California was thus effectively without a government after it became American territory.

As word of the discovery of gold at Sutter's Mill spread, people from around the world began to head for California and their chance at riches. The new arrivals quickly swamped the existing population and institutions. Faced with an almost total absence of government and the opportunity to get rich by, almost literally in many cases, picking up gold off the ground, the new arrivals had little time for politics. As most intended to stay only long enough to make their fortune, they had no reason to invest their time in anything but searching for gold or running businesses catering to the miners.

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(It was the latter who profited the most from the gold rush.)

Under these conditions, one might expect violence to be endemic. Such expectations could only be increased by the demographics of the mining boom: primarily armed single young men, from a wide variety of cultures and nations, sharing only a desire for wealth. Rather than violence, however, the California gold-rush miners chose contract time after time. Virtually every major mineral find in California, and throughout the West, was organized by the locators into a mining district with rules agreed on, property rights established and respected, and violence kept to a minimum.

On locating a promising site, the first group to arrive would designate one member record-keeper, establish rules governing claim size (roughly the amount of property that could be worked in a single season by the current technology), set down minimal regulations (primarily tort-based rules forbidding such things as theft, assault, and murder), and establishing boundaries. Later arrivals had a choice of accepting the rules or moving on. Because miners quickly found that there was profit to be had in selling claims, early rules restricting claim transfers were done away with rapidly and free transfer of claims became the norm. So secure were property rights that miners could leave their claims marked in the agreed fashion while fetching supplies from larger camps several days away and rarely suffer theft of the valuable tools and goods they kept in their camps.

So secure were property rights that miners could leave their claims marked in the agreed fashion while fetching supplies from larger camps several days away and rarely suffer theft of the valuable tools and goods they kept in their camps.

In addition to the general conditions of peace and order that prevailed—something true of the west generally, where the stereotypical gunfights of movie fame rarely took place and where overall levels of violence were below contemporary levels in the large cities of the east—mining camps were noted for their minimalist approach to law. In a society where the opportunity cost of collective action is giving up the chance to pick up gold from the ground, miners had little incentive to devote their time and resources to anything but creating wealth. As a result, their legal codes forbade the use of force against others and theft—and little else. No one wanted to be in charge of prisoners, so punishments were generally limited to banishment; physical punishments such as ear cropping and flogging, which left criminals marked as prior offenders; and death. Record-keeping was done by an elected registrar, who was paid a fee by those using his services to compensate him for time away from mining.

Only as the population of non-miners grew did specialists in "mining the state" appear and seek to enrich themselves through the use of the state's power. Corrupt official judges, for example, plagued the west while there are virtually no claims of corruption from the miners' tribunals.

Miners' law was far from perfect, but it was no worse than, and often superior to, contemporary state law. Anti-Chinese prejudice led many camps to bar Chinese miners, but the Chinese were able to organize their own mining camps in many areas and secure their rights to the property they established there. What they could not avoid were California's official laws, which included discriminatory taxes and other restrictions.

Vigilantes

Located far from official law enforcement, western communities attacked by criminal elements were forced to defend themselves. Two vigilante efforts in Montana Territory shed some light on how property rights can be defended in the absence of the state.

Montana's first gold rush occurred in the Bannack-Virginia City area in 1863–64, bringing hundreds of miners to the remote region. Among them was a Californian named Henry Plummer, who soon organized a criminal gang that proved efficient at separating miners from their money. Using a spy in the stage office, secret codes chalked on stagecoaches, and Plummer's unofficial position as "sheriff" of the two communities, the gang

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robbed and killed over a hundred men.

At first the miners were helpless to resist the well-organized criminals since no one was willing to stand alone against the force the Plummer gang could muster. The ability to resist the gang's depredations was further reduced by the lack of long-term reputations, which would have fostered trust among the miners in the area. With little social capital and unsure who was involved in the gang and who was not, those outside the gang did not know whom to trust and so could not organize against it.

This problem was solved by the chance discovery that there were several Masons in the area. The bonds between Masons provided the basis for the organization of a vigilance committee to counter the Plummer gang. The Masons discovered one another when a man dying of natural causes gave a Masonic sign to his friends and discovered that two were also Masons. The dying man asked his friends for a Masonic funeral and they agreed to attempt to find enough fellow Masons to bury him with full rites. After canvassing additional miners, they located three more Masons and planned the funeral. Word spread, and on the day of the funeral 77 Masons were present.

Because the Masons trusted one another they were able to overcome the problems that had prevented an earlier response. (The vigilantes adopted 3-7-77 as their symbol and the best guess today as to the symbol's meaning is that it commemorates the number of Masons at each of these first meetings. The numbers adorn the shoulder patches of Montana state troopers today.) Although the Plummer gang attempted to infiltrate the vigilance committee, it was never able to do so because the Masons excluded all those of whom they had suspicions. After a winter campaign 22 members of the gang, including Plummer, were captured and hanged; the remainder fled the territory.

One of the most remarkable things about the first Montana vigilance committee was its failure to use its power to settle personal or political scores. Most historians agree that the committee made at most two "mistakes." One was the hanging of the notorious "Captain" Joseph Slade, a larger-than-life figure who was featured in Mark Twain's account of his time in Nevada and whose regular exhibition of ears he had cut off in barroom fights earned him free drinks. After Slade repeatedly made threats against the committee, it preemptively hanged him to prevent his promised attack.

The other mistake was wrongly identifying a Mexican as part of the Plummer gang. This record is remarkable compared to contemporary state legal systems in the more "civilized" portions of the United States. It is all the more so because Montana was riven with factional disputes between Confederate and Union sympathizers, whose antipathies ran so deep that they lived on opposite sides of the creek that ran through Bannack. There is no evidence of sectional score-settling in the operation of the vigilance committee.

> Two vigilante efforts in Montana Territory shed some light on how property rights can be defended in the absence of the state.

The second Montana vigilance committee operated 20 years later, stopping a gang of rustlers in eastern Montana and western Dakota Territory. Led by Granville Stuart, a Montana rancher, this committee operated more quietly and left fewer records. As Stuart later wrote, "The civil law and the courts had been tried and found wanting. The Montana cattlemen were as peaceable and law-abiding a body of men as could be found anywhere but they had $35,000,000 worth of property scattered over seventy-five thousand square miles of practically uninhabited country and it must be protected from thieves. The only way to do it was to make the penalty for stealing so severe that it would lose its attractions."

Again, however, the historical consensus is that it fought only against a gang of rustlers that raided ranches across the area in the mid-1880s. Certainly their contemporaries had no problems with the vigilantes' activities: The vigilantes won praise from most Montana newspapers at the time; Granville Stuart was elected president of the Montana Stockgrowers Association in the midst of the committee's operations; and James Fergus, a strong defender of extra-legal activities, was elected president of the Montana Pioneers Society and had a

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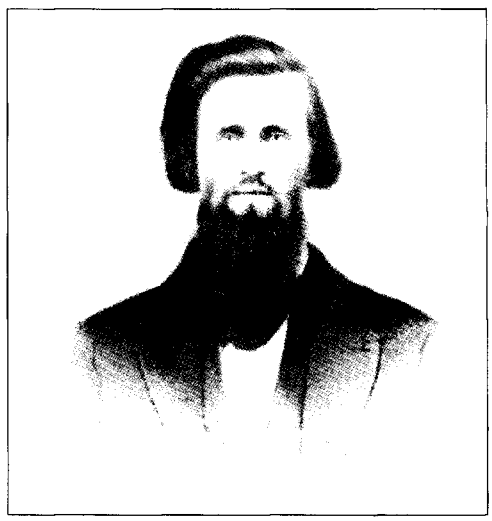
new county named after him in 1885. Moreover, despite numerous contemporaneous conflicts over access to the range between ranchers and homesteaders, there is no evidence that this group attacked any of the ranchers' political opponents.

Vigilantism today has a bad name, largely due to the higher-profile vigilance committees that in effect conducted a coup d'état in San Francisco in 1856 and the southern white-supremacist vigilantes. Both groups' activities undermined rather than reinforced property rights. The important lesson from the Montana vigilante experience is that the absence of state authority does not have to produce a Hobbesian war of all against all.

Why did the Montana vigilantes succeed? Three factors made them successful examples of private law enforcement. First, everyone involved in both committees had high opportunity costs for their time. Just as the gold miners in California had to give up time gathering gold (and perhaps finding the big strike that all miners dreamed of), so the Montana miners and ranchers who made up these efforts could profit more from engaging in mining and ranching than they could by stealing their neighbors' property. The incentive to institutionalize their power into a means to confiscate rivals' property didn't exist.



Granville Stuart

Second, the general problem with private law enforcement is not that there will be too much of it but that there won't be enough. Economists refer to this as the "free rider" problem because of the temptation we have to "free ride" on others' efforts. If my contribution to the vigilante effort isn't going to determine its success or failure, I might as well stay home (where I am safe and warm) and let the rest of the group risk death and injury chasing vicious bandits in the snow. If everyone feels that way, of course, the effort does fail. Indeed, one participant said, "The people bore with crime until punishment became a duty and neglect a crime." The Montana vigilantes overcame this problem by drawing on preexisting groups. In the 1863–64 committee the Masons formed the core group and the loyalty the group inspired in its members was enough to overcome the individual incentive to free ride. The 1884 committee was formed out of the regional cattlemen's association, a group that was bearing the brunt of the attacks. Small-group cohesion provided the means to overcome the free-rider problem.

Third, these two vigilance committees, unlike the southern white supremacists or the San Francisco 1856 committee, were organized to defend life, liberty, and property. The clear mission in support of widely accepted natural rights served to both motivate the members and to constrain the exercise of their power. Men drawn into hazardous volunteer activities, such as chasing criminals, by the need to defend their property and lives could not be easily persuaded to continue such work in pursuit of personal gain.

Cattlemen and Homesteaders

Western cattlemen found their own version of gold on the Great Plains. The buffalo hunters' slaughter left a sea of grass ideal for cattle. The end of the Civil War, the expansion west of the railroads, and the creation of the Chicago stockyards combined to create a vast new market for beef in the 1870s and 1880s. Cattlemen began to trail range cattle up from Texas onto the plains in Wyoming, Montana, and Dakota Territories. Millions of dollars in both domestic and foreign investment poured into the range-cattle industry, with vast ranches springing up in Texas. The XIT, whose brand stood for "ten in Texas" because it covered parts of ten counties, was created by investors who received three million acres in return for construction of the $3 million state capitol building in Austin.

The problem for the cattlemen on the Northern Great Plains (Wyoming, Montana, and the Dakotas) was that federal land policy prevented them from acquiring equivalent tracts there. Texas was happy to sell its state land to anyone who wanted to buy it, enabling Texas ranchers to buy large tracts and fence them with the

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newly invented barbed wire. Northern Plains ranchers, by contrast, were faced not only with federal refusal to sell them land but also the federal homestead acts, which gave farmers the ability to obtain crucial tracts around water sources, effectively controlling wide areas of rangeland. Even the railroads, the other large land owners on the Plains, couldn't sell sufficient land for a cattle ranch because their federal grants alternated tracts along the rail to prevent the railroads from gaining a "land monopoly."

Rather than sell land to willing buyers, the approach Texas and most states took, the federal government's homestead policies in the west prevented the rise of a property-rights solution. There are a variety of explanations for the shift from land sales to homesteading during the nineteenth century, ranging from the desire of congressmen from the manufacturing areas to maintain support for tariffs by denying the federal government the revenue from land sales, to the use of settlers on the frontier as an adjunct to army operations in dispossessing Native Americans from western lands. There is general agreement, however, that homesteading's impact on the homesteaders was to, as Richard Stroup put it, allow them to buy land with misery. Homesteading brought settlers to frontier regions before settlement was economically viable and forced them to endure five years of near starvation in many cases to prove up their claims.

One reason that homesteaders paid such a high price in misery for their land was the federal government's refusal to provide adequately sized tracts. Even allowing for some of the mistaken nineteenth-century beliefs about weather (rain would "follow the plow" as farming released moisture from the soil), the federal government's refusal to follow the advice of its own experts doomed many homesteaders to failure. Major John Wesley Powell, for example, clearly explained to Congress in his reports that the acreage limits set with humid eastern conditions in mind allowed farmers far too little land for the arid west's environment. Although the homesteaders were often ultimately unsuccessful in making their homesteads into viable farms, their impact on the cattle range was problematic. In sum, the result of federal land policy was to preclude a property-rights solution on the Northern Plains.

The contrast between the Texas ranches and the Northern Plains cattle operations, often operated by the same partnerships and companies, could not have been clearer. In Texas the ability to fence property induced investment in better quality stock, windmills to provide water, and advances in range management. Northern Plains cattlemen managed to control the open range for a time, relying on institutions such as cooperative roundups and cattlemen's associations to allocate range rights. But these organizations were ineffective against the claims of homesteaders and sheep herders, who increasingly competed with the cattlemen for the grass and water.

> The clear mission in support of widely accepted natural rights served to both motivate the members and to constrain the exercise of their power.

In Texas the large plains ranches welcomed the arrival of farmers, for the ranches profited by selling the newcomers land and supplies. In Wyoming, conflict between homesteaders and cattlemen led to the "Johnson County War," an attempt at mass murder of opponents of the cattlemen in northern Wyoming by a troupe of imported gunmen. The cattlemen also managed to seize control of the territorial and state governments in Wyoming, placing allies in the governor's mansion and both U.S. Senate seats as well as controlling both houses of the legislature.

The cattlemen's quite different experiences in Texas and Wyoming highlight the important role property rights play in creating the conditions for peace and good order. It was the existence of property rights in Texas that ensured a peaceful transition from range cattle to mixed farming and ranching. Texas cattlemen's investments in their range and herds improved both. The Northern Plains, by contrast, saw more conflict and more violence, both caused by the imposition of institutions that prevented the development of property rights.

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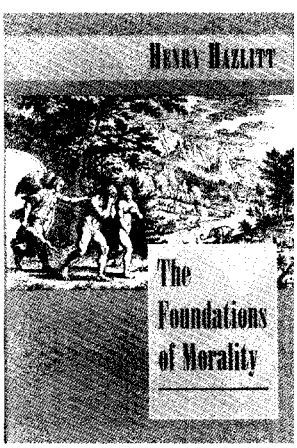
Lessons

What does the frontier experience have to teach us today? There are three kinds of lessons that can be drawn from property rights on the frontier. First, Hernando de Soto refers to the role of property rights as among "the missing lessons of U.S. history" in his analysis of why North America has prospered while Latin America has not. Recovering the lessons of the frontier can remind us of why our society is both free and wealthy.

Second, the evolution of property-rights institutions on the frontier—in the mining camps, on the range, and among the vigilantes—can teach us about the importance of evolutionary institutions. Allowing experience to instruct the law's development, a hallmark of the common-law process, allows the legal system to grow institutions that meet the needs of the society in which they operate. Imposing planned solutions from outside, as the federal government did with the homestead acts, risks falling for the fallacy of central planning.

> The experience of the frontier teaches us that a society built around property rights is one in which peace and good order can prevail.

Most important, the experience of the frontier teaches us that a society built around property rights is one in which peace and good order can prevail. In the mining camps, contract prevailed over violence time and again in a society of armed young men drawn from disparate cultures and lacking any of the social institutions we normally rely on to promote alternatives to violence. The Montana vigilantes showed that individuals could protect their lives and property without provoking a Hobbesian war of all against all. On the Plains the presence of property rights solved the commons problem and eased conflict between farmers and cattlemen, while the absence of property rights led to open warfare.



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Cable-Franchise Reform: Deregulation or Just New Regulators?

BY ADAM B. SUMMERS

There is much hand-wringing and teeth-gnashing among politicians who decry businesses for maintaining monopolies that harm consumers. Yet in a free market such businesses will find any monopoly position fleeting. If they charge too much or fail to provide suitable quality in their products and services, other entrepreneurs will recognize a profit opportunity and jump in to take market share away from them. It isn't enough to obtain a dominant position in an industry; even a "monopolist" faces competitive pressures if it wants to keep that position.

There is an exception to this rule, however: *government-protected* monopolies. If other businesses are prevented from competing with the monopolist through laws, regulations, or exclusive agreements (such as franchise agreements) with the government, there really is no chance of competition. In this case, consumers are harmed because the monopolist has little incentive to provide the lowest prices, the highest quality, or the most innovative products so long as the necessary lobbying is done and tribute paid to the government. This is not a free market. Thus one could say that the only "bad" monopoly is a government-protected monopoly.

One could say that the only "bad" monopoly is a government-protected monopoly.

Today at least one type of government-sanctioned monopoly is starting to break: the cable-television market. Cable-television companies typically have to negotiate with local governments and pay them a portion of their revenues and other compensation for the exclusive right to offer cable services in an area. Few parts of the country have allowed any competition at all in local cable markets, but that is starting to change.

In the past two years state governments have attempted to streamline the cumbersome and costly process of obtaining numerous local government video franchises by allowing cable and telecommunications companies to apply for a single franchise issued by the state. These reform efforts also remove the local monopoly protection, permitting multiple competitors. The change is intended to open up competition, particularly to telephone companies such as AT&T and Verizon Communications, which have been trying to break into the cable market, and to offer consumers greater choice and lower bills.

It should be noted that even where franchise rules prevent competition among cable providers, they may face competition from satellite providers. According to J.D. Power and Associates surveys, satellite providers have increased market share from just 12 percent of U.S. households in 2000 to 29 percent in 2006. During this period, cable providers have seen their share fall from 66 percent to 58 percent. A December 2006 Federal Communications Commission (FCC) report found that satellite competition did not appear to affect cable prices. But this may be because satellite providers often offer more channels and premium services than cable providers do or better new-subscriber promotions, such as free installation and equipment. If so, consumers are getting more for the same prices they would pay for cable. In any case, that

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cable is steadily losing market share to satellite indicates that many consumers feel they are better off with the added competition and services.

State and Federal Reform Efforts

Michigan most recently passed cable-franchise reform when Governor Jennifer Granholm signed the Uniform Video Services Local Franchise Act in December. Consumers and telecommunications companies won another significant victory when California passed the Digital Infrastructure and Video Competition Act of 2006 last September, opening up the state's sizeable market to competition. Under the previous franchise structure in California, a potential cable provider would have needed to gain approval of over 500 separate franchises from local governments to provide service across the entire state. The video-franchising process typically took six to 18 months, resulting in significant costs from business lost during the negotiation process and the time and energy spent on the negotiations themselves, not to mention concessions required by municipal governments as a condition of obtaining the franchise. In response to the California law, AT&T announced that it would invest an additional $1 billion in California through 2008 to upgrade its telephone network and launch an Internet-protocol video entertainment that will compete with cable-television providers. Verizon similarly announced additional investments of "hundreds of millions of dollars" to expand its fiber-optic network, which will allow it to provide television, as well as Internet and telephone, service. These investments are expected to result in the creation of thousands of jobs in the state.

Texas began the reform trend in 2005. In 2006 similar reform measures were passed in California, Indiana, Kansas, Michigan, New Jersey, North Carolina, and South Carolina. Arizona and Virginia also passed reforms, but these measures did not establish statewide franchise authority. In Connecticut and Oklahoma, officials ruled that telephone companies that offer video services through their networks (such as Internet protocol television, or IPTV, platforms) are not subject to local franchise regulation. In addition, a cable-franchise reform bill made it to the desk of Louisiana Governor Kathleen Blanco, but she vetoed it because she feared it would adversely affect municipal-government finances. Still other video-franchise reform measures have been under consideration in Iowa, New York, Pennsylvania, and Tennessee.

> Replacing one set of regulations with another set of slightly more efficient or less burdensome regulations still preserves the general regulatory structure that has led to artificially high prices and stifled both consumer choice and cable and broadband investment.

On the federal level Congress took up cable-franchise reform last year but failed to pass a bill. In June the House of Representatives passed the Communications Opportunity, Promotion, and Enhancement (COPE) Act of 2006, which included a provision that would allow companies to apply for a nationwide television-service license. However, the Senate telecommunications bill, S. 2686, was bogged down by debate over an unrelated "Net neutrality" provision, which concerns whether Internet service providers (ISPs) may charge website owners fees to load their sites more quickly than those of nonpayers, and the measure died.

Action on similar legislation in the new Congress is uncertain, although the momentum built up at the state level could lead Congress to address the issue again. A key factor may be whether cable-franchise reform, which has pretty broad support, will be separated from Net neutrality. Democrats are more likely to call for mandates on this, while ISPs, including telephone and cable companies, want to maintain the flexibility and freedom to offer the services they like and set their prices as they see fit.

FCC entered the fray in December when it voted 3–2 to pass a set of cable franchise-reform rules. The rules require local governments to act on video-franchise applications from new potential competitors within 180 days

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and within 90 days if the applicant has already secured access to local rights of way. The rules also prohibit local governments from requiring competitors to build out their video networks faster than existing cable companies.

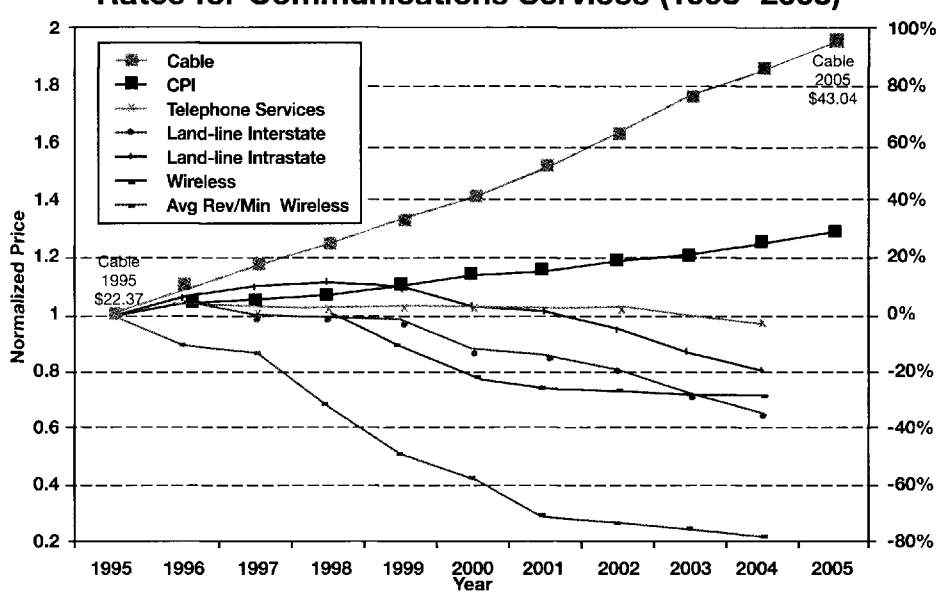
Benefits of Cable-Franchise Reform

Cable-franchise reform benefits consumers in a number of ways. The reduction in costs from seeking numerous franchises from local governments opens up competition to other providers. This competition will lead to greater choice and reduced cable and broadband prices for consumers. (Note that "cable" or "video" services include not only cable television but also data and voice services such as high-speed Internet access and Voice over Internet Protocol [VoIP] telephone service—and perhaps other services not yet anticipated.)

Competition has resulted in significant savings to consumers where it has been allowed to flourish. A study analyzing FCC data on competitive and noncompetitive cable markets found that subscription rates for basic and expanded basic services averaged 16 percent less in competitive markets. In addition, a Bank of America study concluded that when new competitors enter a cable market, existing providers drop prices 28 to 42 percent.

The longer we wait to deregulate, the greater the forgone cost savings. A Phoenix Center study, "The Consumer Welfare Cost of Franchise Reform Delay," estimated that if cable competition were to be delayed another four years, consumers would end up spending $30 billion more nationwide than under a more open market with franchise reform, including $3.1 billion just in California. A March 2006 study by George Mason University professor Thomas Hazlett estimated even greater consumer savings of $9 billion per year from wireline video competition.

Some have argued that franchise monopolies and current regulations are not such a big problem because Congress prohibited local governments from granting exclusive franchises after December 4, 1992. Yet monopolies persist in most areas because of the artificially high barriers to entry created by unnecessary existing regulations. Today only a small percentage of households nationwide are in areas with multiple video operators, largely because of the high costs of entering the market. It should come as no surprise that, according to a 2006 FCC annual report on cable services, between 1995 and 2005, cable rates increased 93 percent while interstate telephony prices *decreased* nearly 40 percent and wireless charges fell almost 80 percent. (See graph.) In discussing the survey's findings at a December 2006 meeting, FCC Chairman Kevin J. Martin concluded: "In recent years, consumers have had limited choice among video service providers and ever-increasing prices for those services, but, as was just demonstrated in our annual price survey, cable competition *can* make a difference and *can* impact cable bills. Again, it found that only in areas where there was competition from a second cable operator did average prices for cable services decrease."



Source: U.S. Federal Communications Commission, *Report on Cable Industry Prices*, Report No. FCC 06-179, December 27, 2006, p. 35, http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-06-179A1.pdf.

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The Downside of Cable-Franchise Reform

The benefits of cable reform notwithstanding, the legislation that has passed is not without a number of drawbacks. While it eliminates the city-to-city quest for franchise approval, it merely centralizes franchise approval authority in a state (and potentially federal) government agency. Thus providers still must seek the government's permission merely to conduct business—only they must do so at the state level instead of the local level.

Cable providers are also typically still subject to numerous "public interest" regulations. They are forced to maintain a number of "public, educational, and government" (PEG) channels (or contribute a portion of their gross revenues to support such programming) that their viewers may not want and/or that may not be economically justifiable. Furthermore, government often continues to dictate where providers may offer their services through "anti-redlining" provisions that force providers to offer all services to all areas, not just higher-income neighborhoods. Competition and technological advances—including satellite-television services—make this less of a concern today than 30 or 40 years ago anyway, but companies should have the right to do business where they want and offer new, experimental, or higher-quality services to higher-income areas to test new technologies and more quickly recoup their investment costs before rolling them out to the rest of their service areas. After all, digital and on-demand cable service is hardly an unalienable right.

Perhaps the greatest concern, however, is that the concentration of franchise power in the state government could actually lead to higher franchise costs and more burdensome regulation in the long run. One of the common complaints of cable and telephone companies is that local governments often engage in extortion by conditioning franchises on payments for numerous pet projects or social causes that may have nothing to do with the franchisee's business.

At the December FCC meeting, Chairman Martin decried the local government practice of conditioning franchise awards on "extraordinary in-kind contributions" (some would call it blackmail or graft) such as requiring applicants to build public swimming pools and recreation centers. Martin made special mention of Lynbrook, N.Y., which required Verizon to provide video equipment for filming a visit from Santa Claus in return for allowing the company to offer services. An October 28, 2005, *Wall Street Journal* article detailed several other examples of the in-kind "contributions" local governments were requiring of Verizon for the privilege of serving their residents. They range from the frivolous to the outrageous. Holliston, Mass., wanted free television for all houses of worship. Massapequa Park, N.Y., wanted $27,000 to plant wildflowers on the median of a four-lane highway and to hang flower baskets to decorate old-fashioned street lights in the village center. Others demanded high-speed Internet for sewage facilities and junkyards, fiber connections to traffic lights for traffic-flow monitoring, and free Internet connections for poor elementary students. When Verizon asked Tampa, Fla., for permission to offer television services, the city presented it with a $13 million "wish list" including money for an emergency communications network, digital editing equipment, and video cameras to film a math-tutoring program for kids.

What would happen if these practices continue at the state level? Imagine that because a state is experiencing a budget crunch or an influential politician has a program he wants others to pay for (I know it's a stretch), you could not do business within the *entire state* unless you agreed to pay the requisite tax (sorry, "fee"). If federal legislation passes, will bureaucrats and influential politicians be able to prevent a company from doing business in the entire country if it doesn't jump through the requisite hoops? Herein lies the problem of allowing politics to interfere with market forces.

While cable-franchise reform like California's and Michigan's represents a step in the right direction, it does not address the heart of the problem: government regulation itself. Replacing one set of regulations with another set of slightly more efficient or less burdensome regulations is always welcome, but this still preserves the general regulatory structure that has led to artificially high prices and stifled both consumer choice and cable and broadband investment. To truly benefit consumers and businesses alike, policymakers must strike at the root of the problem and eliminate such unnecessary regulation altogether.

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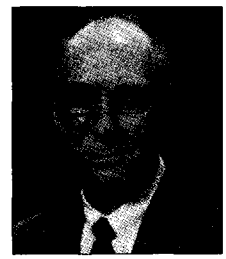

The Great Contraction, 1929–33

BY ROBERT HIGGS

The recession that began in mid-1929 need not have become a disaster. Many downturns had occurred previously in U.S. economic history, and nearly all of them had been fairly shallow and soon followed by recovery and continued growth. In the nineteenth century most people had believed that the government neither knew how nor possessed the constitutional authority to act effectively as an economic savior. They seem to have appreciated that, in Murray Rothbard's words, "[r]ecessions unhampered by government interventions almost invariably work themselves into recovery within a year or so."

The depression of the mid-1890s had been the most severe macroeconomic bust prior to 1929, but despite appeals for government assistance to suffering farmers, unemployed workers, and others, Grover Cleveland's administration staunchly resisted, insisting that the federal government lacked constitutional authority to intervene in that fashion and that the public ultimately stood to benefit the most by upholding free markets.

By the late 1920s, however, many reputable observers had come to believe that the economy had entered a "new era" in which government and business leaders understood how to counteract any recession that might occur before it became severe. Unfortunately, the knowledge they imagined themselves to possess in this regard was for the most part nothing more than an instance of what F. A. Hayek later called the *pretense of knowledge*—the conviction that government planners, including the monetary authorities, know how to make the world a better place than it would be if people were simply left to their own devices.

So, although in previous economic downturns hardly anyone had expected the government to take vigorous action to bring about recovery, by 1929 the dominant ideology had changed substantially. Many opinion leaders and large segments of the general public had embraced the Progressive faith in activist government. To make matters worse, the economics profession for the most part had come to believe that the government could and should intervene actively in economic life.

By the late 1920s many reputable observers had come to believe that the economy had entered a "new era" in which government and business leaders understood how to counteract any recession that might occur before it became severe.

These ideological and intellectual changes came as music to the ears of many politicians, who welcomed a plausible excuse to enlarge their powers and to turn the exercise of those enlarged powers to their own advantage. Organized special interests also seized on the new ideas and attitudes as pretexts for the creation of pensions, subsidies, insurance benefits, bailouts, barriers to competition, and other privileges they sought from government.

As officials at all levels responded to the newly strengthened demands that government "do something" in late 1929 and afterward, the government carried out an enormous number and variety of interventionist measures, spanning every industry, region, and demographic group in the country. Many of these schemes simply reestablished under new

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names the measures that had been used during the recent war, on the ill-considered ground that since these policies and programs had proved successful in a previous emergency (war), they would prove successful again during the existing emergency (economic depression). As President Herbert Hoover declared, "We used such emergency powers to win the war; we can use them to fight the depression." So, for example, the defunct War Finance Corporation was revived in 1932 and called the Reconstruction Finance Corporation.

Because the government's economic-rescue programs often worked at cross purposes or impaired the operation of the private competitive economy, they exacerbated the downturn between 1929 and 1933, making it deeper than it otherwise would have been, and they slowed the economy's recovery after 1933, so that even when the government began to shift the economy onto a war footing in mid-1940, full recovery had not yet been attained—the official unemployment rate in 1940 was 14.6 percent (if persons enrolled in government emergency employment programs are counted as employed, the unemployment rate was 9.5 percent). In short, the government's cures made the disease much worse and slowed the patient's natural recovery.

The dimensions of the disaster were shocking. For nearly four years, with only brief and abortive reversals, the economy fell deeper and deeper into the trough. By 1933 real gross domestic product had declined 30 percent. Production of consumer durables fell 50 percent, producer durables 67 percent, new construction 78 percent, and gross private domestic investment almost 90 percent. The real value of U.S. exports and imports dropped nearly 40 percent. The unemployment rate reached almost 25 percent, and perhaps one-third of those still employed in 1933 were working only part-time. Prices fell on average about 23 percent. Banks failed in waves, and by the end of 1933 nearly 10,000 of them had gone under.

In 1931, 1932, and 1933 the after-tax profits of all corporations added up to less than zero each year. Rental and proprietary income dropped more than 60 percent. The stock market hit bottom in 1932, having lost more than 80 percent of its value. Farm-product prices fell more than 50 percent; net income of farm operators declined nearly 70 percent, and thousands of farmers surrendered their homes and farms to mortgage lenders and tax collectors. Three states—Arkansas, Louisiana, and South Carolina—and approximately 1,300 municipalities defaulted on their debts, and many other states and local governments verged on default.

Smoot-Hawley Act

Among the most harmful of the counterproductive policies implemented during the Great Contraction was the Smoot-Hawley Act in 1930, which lifted import taxes to an all-time high and set in motion a tariff war, a trade-constricting sequence of action and reaction around the trading world. In late 1929 President Hoover urged employers to maintain real wage rates despite the plummeting demand for their products. Many of the largest employers did so in 1930 and into 1931 and, as a result, unemployment increased much faster than it otherwise would have. The Revenue Act of 1932, which became fully effective in 1933, raised taxes by a greater percentage than any previous peacetime tax act, administering a stunning blow to already-struggling households and businesses.

Perhaps worst of all, at the Federal Reserve System, which had been created in 1913 to provide emergency liquidity to commercial banks during financial panics, officials stood by while banks failed by the thousands, bizarrely convinced that in the circumstances they had done all that they could and should do to prevent the banking system's collapse. As a result, the money stock (M2 measure) fell by 32 percent between June 1929 and June 1933. As banks failed and depositors clamored to draw down their bank deposits and to augment their cash holdings, financial stringency took an enormous toll on households and businesses throughout the country.

Owing to the foregoing policies and many others that might be mentioned if space permitted, the economic downturn that began in 1929 turned out to be not simply another recession, quickly reversed, but a catastrophe that persisted for more than a decade. As the emergency spread across the entire trading world, it fostered takeovers by aggressive collectivist governments in several important countries, including Germany, where the ascendancy of the Nazis hastened the onset of World War II.

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Visible and Invisible Hands

BY DOUGLAS J. DEN UYL AND DOUGLAS B. RASMUSSEN

It has often been said that markets are led "as if by an invisible hand" to bring about order and cooperation among people. Markets use incentives and mutual interests to achieve this harmonious result. But there is another, "older" mode of organizing people, namely to organize them around what is "good" or "right." That would seem to be the way of ethics. Ethics, in contrast to markets, seems to organize people around authoritative commands and directives.

This raises a question: how can it be said that self-regulating and spontaneously ordered markets in any way depend on or use ethics? Does it even make sense to encourage ethics in a system that is spontaneously produced and self-regulating? Are not these two opposed, rather than complementary, principles of organization?

In short, what exactly is the connection between the visible hand of ethics and the invisible hand of the market?

Liberal market orders make little reference to moral norms as a basis for solving the problem of coordinating people in society. Most of the time we do not even know the persons with whom we interact well enough to formulate any ethical judgments about them at all. This "impersonality" is certainly a good thing. We can interact with, and benefit from, more people in more ways than if we had to worry about whether their view of right and wrong was the same as ours, or whether they adhered to the same principles as we do. In markets we trade for mutual advantage and then go about our business.

How can it be said that self-regulating and spontaneously ordered markets in any way depend on or use ethics?

Some have therefore claimed that the market order is at best amoral and possibly immoral. Others still cling to the idea that markets produce "chaos" and want something more like an ethical directive to serve as the basis for social cooperation. That would certainly seem to insure that ethics somehow gets into the picture, but it may rest on the completely false notion that markets produce chaos. So let's keep to the idea that markets can coordinate people perfectly well on the basis of mutual interest and consent. Assuming that, why do we need ethics? And more generally, even if we find some use for it, isn't ethics going to be of minor importance in a market order?

First, we know that in any social order we cannot allow people to do *whatever* may interest them. We shouldn't be allowed to set up Murder Inc. So it seems we need some kind of rules even within a market system. This suggests right off the bat that ethics has a role to play in setting those rules. But then, why not let ethics set up everything? Why, in other words, do we consult ethics for some things and not others? We could say that we stop doing ethics when the market approach of using interests rather than commands starts to work better than the visible hand of ethics. This response, unfortunately, brings us pretty much to a standstill in terms of how to proceed.

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On the one hand, for example, there could be those who are less interested in what works and more interested in being sure that people do the right thing. On the other hand, there are those interested in what works, but who might have different opinions about what works better than what. Finally, besides those few who don't think markets really work at all, there are those who might say that markets are okay in very limited spheres, but that ethics should really be the dominant way in which to organize people. All these qualifications seem to stand in the way of a robust defense of the liberty offered by the market. And if we went the other way and gave in to a largely market system, we would seem to be encouraging a culture of interest rather than one of ethical responsibility, since ethics seems to be so little referred to in the daily workings of the market.

We, however, believe that this apparent "ignoring" of ethical concerns is not only justified but is actually a kind of celebration of ethics. In a certain sort of way, less is more. A lot less concern about adherence to commands and directives at the public level may mean a good deal more respect for ethics generally. We're not saying that the liberty of the market will make people more ethical. We might believe that's possible—even generally true—but whether true or not, our point is different. We're saying that this way of organizing society—giving people some simple rules and allowing them to interact with each other based on their mutual interests, agreements, plans, or projects—is an approach that gives ethics utmost importance in society. By "utmost importance" we don't mean we'll necessarily get more ethical behavior or that the society will work better. We mean that the society will in some important way give ethics a critical role to play in its structure.

In this connection there are really only two ways to go. Either society is structured around some ethical principle or set of principles such that the purpose of the society is to live according to them, or society takes some ethical principles to be central to it while leaving others for people to follow on their own. Obviously, the market society, or "liberal" order, is an example of the latter. Of course, that just poses our same question: which principles should be at the center and why?

Perhaps we can get at this question a bit differently. Instead of assuming we're all clear on what ethics and politics means, let's ask some basic questions. For example, just what is ethics? We take ethics to be an investigation of how one ought to live. That means specifically what actions one ought to take to live well. Put in these terms, one thing that immediately jumps out is that the answer to this question for one person may not be the same as for another. If this is true, then the market order is certainly one that allows for and indeed encourages a pluralism of ways of living. That's not our main point here, but it is something important to remember when thinking about ethics and the market. If there can be more than one way to live well, then the market may be the best organizing principle in recognition of that truth.

> The first principle of social order must be to protect the possibility of self-direction.

Of course, one might live badly under freedom and pluralism as well. The market order may allow someone to misuse or abuse his responsibility to live well. It would seem, then, that the market order (in the abstract) is neither a supporter of nor a detractor from the good life. It could go either way in any individual case. But that may not quite settle the issue. For in asking ourselves what ethics is, we might also want to ask what social problem we are trying to solve that brings us to this question about ethics in the first place. We already know part of the answer. We need some rules to live by when we're in the company of others.

But in light of what we've said, those rules have to do two things at once. First they have to apply equally to everyone in the society. We can't have them applying to some people and not others, because these are the basic rules for society as a whole. By the same token, they have to apply to everyone while at the same time recognizing that there may be different ways of living well. This means that they need to recognize the pluralism we've spoken about while still somehow treating everyone the same. We cannot fall back into the trap of making everyone live a certain kind of life. That would violate the variety we've already said is necessary for eth-

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ical pluralism and which is generously allowed by the market. We also cannot go to a position that gives up on general rules. That would make it unclear how to deal with each other when we don't know if we share the same ethical principles. We've got to be both general and specific at the same time with whatever basic governing principle of society we adopt.

It still seems like we're at an impasse. What kind of rule or principle could possibly both speak to everyone at the same time, allow for plural forms of living well, and not at the same time bias things in favor of one form of living well over others? What principle could possibly serve such a role?

Different Types of Ethical Principles?

Before answering this question we need to be open to one more possibility. It might just be the case that not all ethical principles are the same *type* of thing. Maybe some ethical principles are of one type and others of another, and thus only some are really relevant to our problem here. Another way of putting the matter is to suppose that maybe some principles are appropriate for solving the problem of how to live among our fellow human beings and others about how to live well. Yet that cannot be quite right either, for living well involves living among others. Maybe, then, we need principles that speak to the very *possibility* of living well among others and principles that speak to living well, including among others. If you're open to that, we think we're ready now to see the answer to our problem.

What is it, then, that a) can apply to everyone, b) can apply to every ethical situation, c) does not bias society more in the direction of one way of living well over another, and d) is something each of us has an ethical interest in every time we act? Could there possibly be such a principle?

We think there is: the principle of "self-direction." More specifically, the principle is that the first principle of social order must be to protect the possibility of self-direction. By "self-direction" we don't mean anything complicated—just the ability to make and exercise choices as an acting agent. One doesn't have to be autonomous—that is, in full possession of all relevant information and powers of reasoning—nor does one have to be choosing rightly. One simply has to have the ability to make choices within whatever system of constraints one confronts. We have such a simple understanding of self-direction because for any act to count as ethical it has to be something one chooses or is responsible for. If one didn't actually choose the action or could only be responsible for it when she had full information or god-like understanding of the situation, then there wouldn't be much ethics around.

The most obvious and common way to impede self-directedness is with the use of physical force. There may be other ways, but physical force is easily recognizable by all and more or less easily prevented. Because our basic principle has to be general and public, we need to have one that is relatively easy to identify and not over-subtle and qualified. The usual list of crimes, such as theft, rape, murder, assault, fraud, and the like, serves this criterion quite well. If we don't allow these things in society, there is a strong presumption of self-directedness when we see people acting.

The most obvious and common way to impede self-directedness is with the use of physical force.

In protecting the possibility of self-directedness, it should be clear that we're not trying to make people good or even increase their effectiveness in being self-directed. What we're really trying to do by protecting the possibility of self-directed behavior is to give ethics a chance. Indeed, if, as we believe, self-direction is at the base of every act that is to count as ethical, the surprising conclusion is that it is the market system that, in giving liberty pride of place, actually gives ethics the most chance!

We still don't have a completely ethical society in protecting the possibility of self-directedness. That would depend on whether the people exercised their freedom in ethical ways. Notice though that if you don't exercise yours in this way, it doesn't keep me from exercising mine, since what we're protecting is the possibility for self-direction—not particular forms of self-directed conduct. Notice, too, that if we try to

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enforce more than the possibility of self-directedness, we're very likely to begin to bias things in favor of some forms of self-directedness over others. It seems that either we must embrace liberty completely as our social principle or not. But if we do not, the surprising conclusion is that we're also abandoning a commitment to what is central and necessary for any act to count as ethical. We must, in other words, keep in mind one type of ethical principle in order to protect another—in this case what is fundamental to all other acts in a social context. If we reverse the priorities, we may actually be destroying the foundations of ethics.

Making Ethical Actions Possible

It may seem that market societies are indifferent or ambivalent about ethics, but if so it is because they and only they recognize that there's a difference between ethical principles that make ethical actions possible in society and ethical principles that guide us in what we need to do to live well or fulfill our obligations to ourselves and others. This is another way of saying that the market order, for good reason, does not want to be understood as an ethical philosophy. It isn't a philosophy of ethical living. It is rather an answer to the limited question of what is the role of ethics in organizing society. The answer is simply that it should be organized to protect the possibility of ethical behavior, and attempts to do more will actually compromise that basic goal. That may be some distance from a philosophy of living, but it is in accord with the truth that living well can only be accomplished by individuals who are responsible for their own actions.

We can say by way of conclusion about liberal market orders, therefore, that they and only they exhibit *a profound recognition of the centrality of self-directedness to morality and thus a recognition of the need to protect it.* This recognition would thus naturally manifest itself in a suspicion of any effort to replace self-direction with some form of predetermined moral trajectory, however appealing or compelling such a program of direction might be. The norms protecting self-direction can only be altered in the name of self-direction, otherwise self-direction must be left alone to be exercised. The hidden wisdom of classical liberalism, and indeed the reason for its incredible practical success and power, is the insight that the less ethics is an object of political concern, the more it has a chance to flourish socially. While there is solid evidence to support the contention that liberal orders make people generally better off, what is perhaps less well noticed is that liberal orders allow something deeper and more profound. They allow people to be human—that is, they allow people to employ their peculiarly human capacities of reason, judgment, and social sympathy toward ends and purposes they themselves have chosen. The market order is not, then, a dehumanizing institution, but the most human, and ethical, of them all.

Society should be organized to protect the possibility of ethical behavior, and attempts to do more will actually compromise that basic goal.

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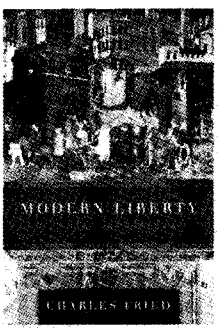
Book Reviews

Modern Liberty and the Limits of Government

by Charles Fried
W.W. Norton • 2007 • 217 pages • $24.95

Reviewed by Richard M. Ebeling



In calling his book *Modern Liberty and the Limits of Government*, Charles Fried, professor of law at Harvard University and former solicitor general of the United States in the second Reagan administration, was inspired by the early nineteenth-century French classical liberal Benjamin Constant. In 1819 Constant delivered a lecture in Paris called "The Liberty of the Ancients Compared to the Moderns."

Among the ancient Greeks, Constant explained, freedom meant the ability of the free citizens of the city-state to debate and vote on the affairs of their community. Liberty, in other words, referred to collective decision-making to which all individuals were bound, since through the "democratic" process they had given their consent—regardless of how tyrannical the outcomes might be for their personal lives and fortunes.

Constant contrasted this majoritarian and communal conception of "freedom" with the nineteenth-century classical-liberal ideal of liberty: "It is the right of everyone to express their opinion, choose a profession and practice it, to dispose of property, and even to abuse it; to come and go without permission, and without having to account for their motives or undertakings. It is everyone's right to associate with other individuals, either to discuss their interests, or to profess the religion which they and their associates prefer, or even simply to occupy their days or hours in a way which is most compatible with their inclinations and whims." For the moderns, Constant said, liberty consisted of "peaceful pleasures and private independence." Modern men want "each to enjoy our own rights, each to develop our own faculties as we like best, without harming anyone. . . . Individual liberty, I repeat, is the true modern liberty." (See my review of Constant's 1815 book, *Principles of Politics Applicable to All Governments*, in the June 2004 *Freeman*.)

Fried wants to restore Constant's ideal of liberty against the statist trends of our time. Indeed, in his preface he expresses hopes that his book can do for the contemporary world what F. A. Hayek's *Road to Serfdom* did more than 60 years ago in helping to stem the tide of government power. Unfortunately, while many parts of his book are insightful, Fried shows that he too has been captured by a great deal of the "ancient" notion of liberty.

He defends the idea of self-ownership as the most fundamental basis for individual liberty. He argues that the most intimate aspects of self-ownership are control over our own minds and bodies. What meaning can be given to liberty if the individual is not respected and secure in his right to think, speak, and write? If you don't own your own mind and have the liberty to express your thoughts free from government control, then at the deepest level freedom does not exist.

Likewise, if you don't own your own body, then surely you are a slave to whoever claims the right to use and abuse your physical person. One of the most intimate forms of such physical self-ownership, therefore, is the liberty of consenting adults to choose sexual partners and sexual acts. Fried therefore defends both heterosexual and homosexual relationships as a fundamental right of any individual to decide with whom to share such intimacy—even though some people will find another's choice of partners offensive.

The trouble arises, Fried says, when self-ownership over mind and body is extended to the physical objects around us. Fried understands that without private property, all issues of self-ownership fall to the ground. What meaning is there to freedom of speech if individuals may not have some degree of ownership and control of the resources through which speech may be expressed? He understands that property has been the engine of prosperity and innovation that has raised man up from barbarism. And he emphasizes that such property rights, like the rule of law in general, must be secure and stable if we are to be able to plan for the future and have trust in our dealings with each other.

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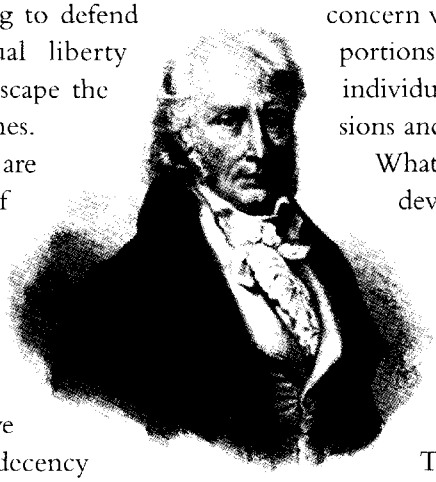
To secure rights under the law, Fried argues, there must be a government to serve as the arm of enforcement. Thus we have an obligation to part with a portion of our wealth and income to fund the provision of that security. In addition, he insists that it is the duty of government to supply a variety of "public goods," such as roads, parks, and streets, that may not get funded without taxation because some may try to free-ride on what others contribute.

However, the public-goods argument soon takes Fried down a slippery slope. From roads and streets he extends this rationale for government activity to education, health care, and a variety of other items in the grab bag of the modern welfare state. How does his slide down this slope begin? While wishing to defend Constant's conception of individual liberty against state compulsion, he cannot escape the rationale for these redistributive schemes.



Benjamin Constant

We may be individuals, but we are born and nurtured in a community of other human beings. Our language, beliefs, ideas, customs, and culture all come from the wider social order to which we belong. Fried contends that we have duties to this wider community without which we would not be who we are. Common decency requires us to not turn a blind eye to the hardships, misfortune, and maltreatment of our fellow men. The state, Fried believes, is the means through which we all participate in and contribute to what we owe to that larger community.

What Fried misses in his argument about the nature and role of government is that the *state* is not the same thing as *society*. The state is that agency in society that either is delegated or usurps the legitimate use of violence to enforce its laws. But society is the wider concept that represents the associations individuals form among themselves. It is through these institutions of civil society that free men cooperate for mutual benefit and furtherance of shared values.

The role of government in a truly liberal order is to secure and protect the rights of free persons so they may go about their peaceful business. Government becomes especially dangerous to liberty when it exceeds those limited duties. It by necessity diminishes and finally threatens the existence of liberty when it replaces associations and activities of free persons with its own monopoly control and exercises its regulatory or redistributive power through the threat or use of force.

Fried has bought into the statist premise that coercion must replace consent if enough people don't act in decent and moral ways toward others. But there is no moral conduct when the individual has no choice in the matter other than to obey those who hold the threat of force against him. Nor can we be sure that the best means have been found to further those goals of "social" concern when the government taxes and distributes portions of people's incomes rather allowing those individuals the freedom to make their own decisions and commitments.

What Fried and many others are trying to do is devise ways of making freedom compatible with the welfare state. Accept a certain minimum of such "social work" by the government, resign yourself to paying some part of your income to finance them, and then be content with the "liberty" to use what's left in our pockets. The task, in Fried's view, is somehow to limit what government does in these areas so it doesn't become too tyrannical and overbearing.

Thus by a roundabout route, Fried returns to the liberty of the ancients over the "modern" liberty of individuals so brilliantly defended by his hero Constant. In fairness, it must be said that Fried challenges and undermines many of the more recent arguments for greater state control. He often does so in creative and thought-provoking ways.

Nevertheless, his book is more an attempt to reconcile liberty with the welfare state than a strong case for extending liberty by reducing and abolishing the compulsory redistributive political order in which we live.

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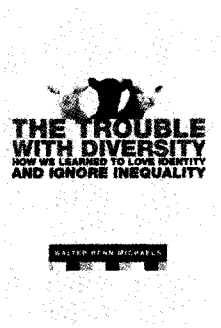
The Trouble with Diversity: How We Learned to Love Identity and Ignore Inequality

by Walter Benn Michaels
Metropolitan Books/Owl Books • 2006/2007 • 241 pages • $23.00 hardcover; $15.00 paperback

Reviewed by George C. Leef



"Diversity" has become a true sacred cow to many on the political left. The extent of the worship was displayed in the September 29, 2006, issue of *The Chronicle of Higher Education*, which featured a 40-page supplement devoted to diversity on American campuses. At Washington State University, for example, there is an official bearing the title "vice president for equity and diversity." The annual budget for his office is $3 million, and he has a staff of 55. No doubt about Washington State's commitment to diversity.

The Supreme Court fell for the diversity pitch in its 2003 *Grutter v. Bollinger* decision, saying that states have a "compelling interest" in obtaining the educational benefits that diversity supposedly provides.

A few people have stuck their necks out to criticize the diversity mania. Peter Wood, for example, took an unflattering look at it in his book *Diversity: The Invention of a Concept*. He and virtually all other critics have been on the right. In *The Trouble with Diversity*, however, author Walter Benn Michaels attacks from the left. Michaels, a professor of literature at the University of Illinois-Chicago, isn't so much upset with the infatuation with diversity per se as he is that its advocates have, in his view, been seduced into the pursuit of a false idol. Michaels is an old-fashioned egalitarian, and he sees the diversity crusade as a terrible distraction from what ought to be the central, overarching goal of the left—redistribution of wealth.

Here is how Michaels puts his argument: "Giving priority to issues like affirmative action and committing itself to the celebration of difference, the intellectual left has responded to the increase in economic inequality by insisting on the importance of cultural identity. So for thirty years, while the gap between the rich and the poor has grown larger, we've been urged to respect people's identities—as if the problem of poverty would go away if we just appreciated the poor."

Michaels isn't arguing, therefore, that the push for diversity is harmful in itself, but only that true leftists ought to be out demanding more taxes on the rich and programs to help the poor. There isn't anything in the book on the problems caused by our diversity obsession—such as how it undermines performance standards and breeds contempt for its supposed beneficiaries.

The book does manage to land a few good punches, especially Michaels's well-supported argument that there really is no such thing as "race." He also makes it clear that most of the people who are favored by diversity policies are not the least bit needy. The problem is that, for the book to succeed, it also has to carry two additional points: that government policies can significantly reduce economic inequality and that the pursuit of greater equality ought to be the supreme goal of people on the left. Sadly, the author makes almost no effort on either.

Like all utopian dreamers, Michaels assumes that the only cost of redistributionist policies is that the "fat cats" will have quite a bit less money so that the suffering poor will have more. Can it be that, viewing the world from his office in the English Department, he is unaware of all the work showing that welfare programs change the incentives of people in ways that undermine all the good intentions of their advocates? Perhaps so—there are no references to Charles Murray, for example. Nor do we hear anything about the consequences of income redistribution where it has been national policy. Britain relentlessly pursued egalitarianism after World War II. By the mid-1970s, that country was heading for economic ruin as both human and financial capital fled. *The Trouble with Diversity*, however, ignores all the troubles with egalitarianism.

Furthermore, even if the leftist reader at whom Michaels aims the book agrees that diversity is the wrong goal, why should he agree that equality is the right goal? If someone thinks that the most important social change to work for is peace, for example, there's nothing in this book to change his mind. It doesn't seem to occur to Michaels that people on "his side" might conclude that his egalitarianism is just as quixotic as the diversity crusade.

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Lastly, Michaels makes himself Exhibit A for the long-standing contention that many leftists care about people only in the abstract. He is honest enough to admit that when he sees homeless people in Chicago, he doesn't give them assistance but just wants them to go away. It's the government's job to solve that problem, you see.

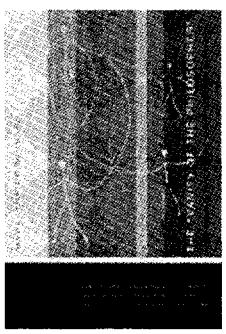
The only lasting impact of this quirky book will be to make its wealthy, leftist author somewhat more wealthy.

George Leef (georgeleef@aol.com) is book review editor of The Freeman.

The "Vanity of the Philosopher": From Equality to Hierarchy in Post-Classical Economics

by Sandra J. Peart and David M. Levy
University of Michigan Press • 2005 • 323 pages • $40.00

Reviewed by Gene Callahan



Economists Sandra Peart and David Levy have written a deeply interesting but ultimately unsatisfying book. While the work uses a major episode in the history of economic thought to cast light on an issue still of great importance today, I believe that the authors' methodological predilections and their misunderstanding of the proper relationship between scientific theory and practical life result in their dancing around the periphery of that issue.

Peart and Levy's central argument is that, under the sway of the racist views current during the late-nineteenth and early-twentieth centuries, economists abandoned the axiom of human equality held by earlier practitioners, such as Adam Smith, David Ricardo, and John Stuart Mill. The authors make a convincing case that what the leading opponents of "classical" economics chiefly rejected was its assumption that human nature is the same everywhere and that people differ primarily due to their unique life history and the particular circumstances and incentives they confront. This implies that an "expert" is unlikely to make better choices for some individual than he is for himself. That egalitarianism was anathema to intellectuals like Charles Dickens, Thomas Carlyle, Francis Galton, and John Ruskin, for whom the white race had the mission of directing the lives of their genetic inferiors. A logical extension of racist thought, especially when coupled with the new understanding of evolution proposed by Darwin and Wallace, was eugenics, which advocated top-down control over human breeding in the interest of "improving the species."

Evangelical Christians rejected white racial dominance based on their belief that, after the Fall, all people were incapable of self-perfection and stood equally in need of God's grace. Therefore, they allied with the classical economists in a number of prominent public debates. For example, both groups demanded the prosecution of the white governor of Jamaica, Edward Eyre, for indiscriminately killing over 400 of his black subjects to quell an episode of civil unrest, and were opposed by the racists, who lauded Eyre for dealing resolutely with "savages" who refused to appreciate the benevolent tutelage of their white masters.

Unfortunately, racist ideas eventually triumphed even in economics, as Peart and Levy demonstrate with quotes from leading economists, including Alfred Marshall, F.Y. Edgeworth, Frank Fetter, and A.C. Pigou. As a consequence, the assumption that each person should count equally when evaluating the merit of some policy was replaced by the idea that certain people may have a significantly greater capacity for happiness than do others, entitling them to preferential consideration.

The authors having persuaded me that the demise of classical economics was closely tied to the increasing weight given to race in explaining human affairs, I kept expecting to reach their debunking of those racial doctrines themselves. But the nearest thing they offered was a mathematical analysis of how folk wisdom could possibly compete with scientific models in guiding decisions.

I found this disappointing for two reasons: First, the proper outcome of scientific research is not practical advice but theoretical understanding, and so trying to measure a scientific model on the same scale as a proverb represents a categorical confusion. Second, it isn't even *that* near to the discussion I hoped to find—in fact, their

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defense of folk wisdom strikes me as being irrelevant to their central concern, because it could be true both that folk wisdom is often a match for scientific experts *and* that the racists were right in that the folk wisdom, say, of the Lithuanians is superior to that of the Latvians.

But Peart and Levy do not merely avoid examining the evidence for racist views: they disparage any effort to do so, asserting that the danger of taking such theories seriously outweighs the value of any scientific truth they possibly contain. Here again, I think the authors suffer from same fundamental confusion as did the eugenicists: theoretical understanding is not a rival of, or potential substitute for, practical judgment. No genuinely scientific theory should be declared beyond the pale because it is politically incorrect. The best safeguard against such horrors as Nazism and Stalinism lies in realizing that even if their key theories were scientifically sound, it would not justify the policies they were said to imply, for such matters can never be resolved based solely on scientific facts but involve ethical judgments as well. For example, there is nothing incoherent in a scientist's hypothesizing that race is an important factor in human action while still regarding racial persecution and discrimination as immoral.

While Peart and Levy have written a fascinating and well-researched book that successfully illuminates an important factor in the transition from classical to neoclassical economics, their work falls short of its promise due to the authors' failure to recognize the gulf separating theoretical speculation from practical reasoning.

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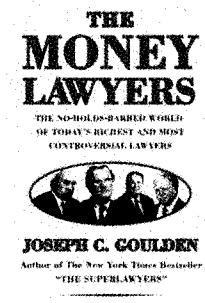
The Money Lawyers: The No-Holds-Barred World of Today's Richest and Most Powerful Lawyers

by Joseph C. Goulden
Truman Talley Books • 2005 • 396 pages • $27.95

Reviewed by Martin Morse Wooster



In good times or bad, whether Republicans or Democrats are in power, trial lawyers are up to no good. But who *are* these people? What sort of lawyer would devote his life to making millions from class-action suits?

Joseph C. Goulden's *The Money Lawyers* is an excellent guide to the lives and ideas of the megalawyers who wage war against American corporations. Goulden is an experienced author who is best known for *The Superlawyers*, a 1972 bestseller that showed what life was like inside major law firms.

Goulden, who describes himself as a "quasi libertarian," is a fair-minded writer and persuaded several trial lawyers to talk to him. Chapters in this book include profiles of Washington insider Tommy Boggs, Microsoft-basher David Boies, and securities lawyers William Lerach and Melvyn Weiss.

Two of Goulden's chapters, however, are about two of the most notorious class-action suits of the 1990s: breast implants and the diet-drug combination "fen-phen." Here Goulden shows why class-action suits don't solve the problems they are meant to correct.

In the breast-implants case, lawyers could show that the companies that made silicone-based implants tried to make the membranes as thin as possible in order to make sure that the implants were as life-like as possible. Because these membranes were thin, they leaked 4–6 percent of the time. Dow Corning, the major manufacturer, was understandably reluctant to reveal this; a 1975 memo from a Dow Corning salesman noted, "I don't know who is responsible for this decision [to sell leaky implants], but it has to be right up there with the Pinto gas tank."

But no one was able to show that the leaked silicone harmed women. That didn't stop trial lawyers from raking in millions by persuading juries that the women they

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represented had illnesses caused by silicone. Trial lawyers also had allies, such as Dr. Sidney Wolfe, head of the Nader-founded Public Citizen and a relentless advocate for bigger government. Journalists also used the "evidence" gathered by class-action lawyers as a basis for sensational stories; most notoriously, Connie Chung charged in 1990 that silicone was "an ooze of slimy gelatin that could be poisoning women."

Goulden sees trial lawyers as having a better record in the fen-phen case, as plaintiffs were able to show that taking fenfluramine and phentermine for long periods did substantially increase the risk of heart disease and stroke. Because of that risk, Goulden believes the jury's decision that these drugs were unsafe was correct.

But when the $2.5 billion settlement with American Home Products was announced in 1999, the plaintiffs expected about 300,000 victims would qualify for payments. Instead of that, millions of victims demanded their share of the billions. Many of these "victims," Judge Harvey Bartle III ruled, were found to be "sick" after only a brief exam by a doctor in Kansas City or another one in New York City. Judge Bartle ruled that the Kansas City doctor was reading up to 165 electrocardiograms a day, and that "her practice resembled a mass production operation that would have been the envy of Henry Ford." As the result of this chicanery, payment to fen-phen victims—and their lawyers—was held up for years.

At least the fen-phen case *had* victims. Goulden shows that securities lawyers often win lawsuits against corporations whose stock price suddenly falls, even if they couldn't show that insider trading or any other illegal activity caused the drop. Moreover, trial lawyers miraculously find investors who make bad investments and eagerly sue again and again. In one three-year period in the early 1990s, one investor was lead plaintiff in over *300* suits in California courts (each one against a separate company) charging that his investment had lost value because of illegal corporate behavior.

In his conclusions, Goulden doesn't hold out much hope that tort reform will curb the trial lawyers since most politicians are lawyers and aren't willing to enact changes that would substantially reduce lawyers' incomes. Rather, he sees the best hope in strengthening the virtues of individual responsibility and self-reliance. For example, he notes that one reason why juries haven't convicted fast-food companies of making kids fat is that most jurors rightly wonder why parents allow their children to get heavier and heavier eating junk food.

"Modern law," Goulden concludes, "has produced a system that is a de facto welfare state, with all of us compelled to pay (through higher prices) for whatever woes befell other persons."

Anyone interested in curbing the growth of the trial-lawyer-driven welfare state needs to read Joseph Goulden's very fine book.

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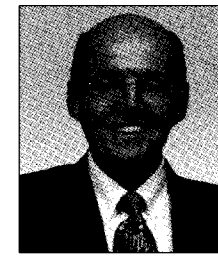
Hayek on Closed Shops and Yellow Dogs



BY CHARLES W. BAIRD

In my December 2006 column I discussed some of Hayek's classical-liberal views on the rule of law and labor unions. In brief, Hayek approved of voluntary unionism based on a correct understanding of freedom of association and the rule of law, and he fittingly condemned most features of unionism as we know it in the United States under the National Labor Relations Act (NLRA). In this column I argue that Hayek's views on closed shops and so-called "yellow-dog" contracts are themselves inconsistent with freedom of association and the rule of law.

A closed shop is an agreement between an employer and a labor union that excludes union-free workers from initial and continued employment. A yellow-dog contract is an agreement between an employer and an employee that, as a condition of initial and continued employment, the employee must be and remain union-free. The NLRA outlaws yellow-dog (union-free) contracts and promotes modified closed (union-only) shops called "union shops." These are places in which a worker does not have to be a union member to be hired, but, as a condition of continued employment, must become a union member after a probation, usually of 30 days.

In Chapter 18 of *The Constitution of Liberty* (1960) Hayek argued that the closed shop, as it emerged under the illicit privileges and immunities granted to unions by the Trades Disputes Act in Britain and the NLRA, is coercive and an affront to the rule of law and freedom of association. He called for the abolition of those privileges and immunities, and predicted that most forms of union coercion would then soon disappear.

I agree, but then he wrote: "[T]he unions should not be permitted to keep non-members out of any employment. This means that closed- and union-shop contracts . . . must be treated as contracts in restraint of trade and denied the protection of the law. They differ in no respect from the 'yellow-dog contract' which prohibits the individual worker from joining a union and which is commonly prohibited by the law."

Here Hayek contradicts himself. In the absence of any special privileges or immunities for unions or employers, the principle of freedom of contract (which is part of the freedom of association) implies that a willing employer has a right to agree with a willing union composed of voluntary members to set up a union-only shop. I wouldn't expect many employers to make that choice, but they should not be prohibited from doing so. If such agreements work in a free-market setting, they will be adopted by other employers and other unions. If they don't work, they will not be adopted. The market will sort it all out. Hayek endorses the principle of letting the market sort things out in other settings. He is not logically consistent when he advocates government interference in market arrangements in this setting.

Similarly, union-free contracts should not be prohibited. A job offer made by an employer to an employee has several components. The compensation package stipulates a wage or salary along with a set of other benefits of various descriptions. The classical-liberal view is that an employer has a right to offer any compensation package he chooses and that the prospective employee has the right to accept or reject the offer. The job description itself (the stipulation of the time, place, and manner of the employee's expected actions on the job) is another part of the job offer. The classical-liberal view is that an employer should be able to make such stipulations and that the prospective employee should be free to accept or reject the offer on the basis of those stipulations. It follows that an employer has a right to stipulate a union-free work environment in his job offer, and a prospective employee has a corresponding right to accept or reject the job offer. Any job offer will consist

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of some things a prospective employee likes and other things he doesn't like. He will settle the tradeoffs in his own mind before he decides to accept or reject the offer.

Hayek claimed that his favoring prohibition of union-only and union-free contracts is consistent with the principle of freedom of contract correctly understood:

> It would not be a valid objection to maintain that any legislation making certain types of contracts invalid would be contrary to the principle of freedom of contract. We have seen before (in chap. xv) that this principle can never mean that all contracts will be legally binding and enforcible [sic]. It means merely that all contracts must be judged according to the same general rules and that no authority should be given discretionary power to allow or disallow particular contracts. Among the contracts to which the law ought to deny validity are contracts in restraint of trade. Closed- and union-shop contracts fall clearly into this category.

The "general rules" by which all contracts ought to be judged are the rules of voluntary exchange.

However, the "general rules" by which all contracts ought to be judged are the rules of voluntary exchange. Hayek usually argued that contracts are legitimate if they emerge out of mutual consent in the absence of force or fraud and if they do not trespass against the just entitlements of third parties. In Chapter 15 he included "contracts in restraint of trade" along with "contracts for criminal purposes" in his list of contracts that government should not enforce, but he gives no convincing explanation for doing so. If "restraint" means excluding others from the competitive market process, then contracts in restraint of trade are not legitimate and should not be enforced. But in a free-market setting, union-only and union-free contracts are not like that. No employee, whether union-free or not, has a right to work for any employer who is not willing to hire him.

Mischievous Role

The term "contracts in restraint of trade" means different things to different people. In particular it has played a mischievous role in the sad history of antitrust regulations. One person's contract in restraint of trade is another's innovative arrangement to cope with market realities. As Dominick Armentano has shown, American antitrust laws have more often been used to protect particular competitors than to protect the process of competition and consumers. I infer from Hayek's condemnation of contracts in restraint of trade in the context of unions that he would support the application of antitrust legislation to them. In my view antitrust legislation should apply neither to unions nor to enterprises. It should be abolished. As long as every union and every enterprise plays by the rules of voluntary exchange, the market process will sort out efficient from inefficient organizational architectures in all markets, including labor markets.

However, the NLRA exempts unions from the rules of voluntary exchange. It grants unions several monopoly privileges that they are free to use to exploit workers, consumers, and employers. Until the NLRA is repealed, it may be useful to apply some antitrust restrictions to labor unions. But that is second best. The classical-liberal solution is to repeal both the NLRA and antitrust legislation and let freedom of contract reign.

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